CLERK'S COPY.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 48

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

JOHN STUART

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

PETITION FOR CERTIORARI FILED MARCH 19, 1942
CERTIORARI GRANTED APRIL 27, 1942

In the
United States Circuit Court of Appeals
For the Seventh Circuit

No. 7695

JOHN STUART,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Review of Decision of the United States Board of Tax Appeals.

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1 John Stuart, *Petitioner*, vs. Commissioner of Internal Revenue, *Respondent*. } Docket No. 97500.

Appearances:

For Taxpayer: Herbert Pope, Esq., Benj. M. Price, Esq., Preston B. Kavanagh, Esq.

For Comm'r: D. A. Taylor, Esq.

DOCKET ENTRIES.

1939

Mar. 14—Petition received and filed. Taxpayer notified. (Fee paid.)

Mar. 14—Copy of petition served on General Counsel.

Mar. 14—Request for circuit hearing in Chicago, Ill., filed by taxpayer. 3/14/39 copy served.

May 2—Answer filed by General Counsel.

May 8—Copy of answer served on taxpayer. Chicago, Illinois, Calendar.

1940

Mar. 22—Hearing set May 6, 1940, Chicago, Ill.

May 6—Hearing had before Miss Harron, Div. 13, on merits. Submitted. Amended answer filed. Stipulation of facts and amendment to answer filed May 8, 1941. Both briefs due 6/20/40; Reply briefs 2/5/40.

May 16—Transcript of hearing of May 6, 1940 filed.

May 19—Brief filed by taxpayer. 6/21/40 copy served on General Counsel.

June 20—Brief filed by General Counsel.

July 5—Reply brief filed by taxpayer.

Nov. 30—Memorandum findings of fact and opinion rendered, Marion J. Harron, Div. 13. Decision will be entered under Rule 50.

Dec. 16—Computation of deficiency filed by General Counsel.

Dec. 18—Hearing set Jan. 15, 1940, on settlement.

1941

Jan. 9—Consent to settlement filed by taxpayer.

Jan. 10—Decision entered, Harron, Div. 13.

Apr. 1—Supersedeas bond in the amount of $49,286.00 approved and ordered filed.

Apr. 3—Petition for review and statement of points by United States Circuit Court of Appeals, Seventh Circuit, filed by taxpayer.

Apr. 5—Proof of service of filing petition for review and statement of points filed.

May 6—Motion for 30 days extension within which to settle the evidence and transmit the record filed by taxpayer.

May 6—Order enlarging time to June 12, 1941 to prepare and transmit the record, entered.

2 May 29—Agreed statement of evidence filed.

May 29—Agreed praecipe for record filed.

Filed Mar. 14, 1939.

3 UNITED STATES BOARD OF TAX APPEALS.

John Stuart,
Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.
} Docket No. 97500.

PETITION.

Filed March 14, 1939.

The above named petitioner hereby petitions for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his notice of deficiency (IT:R:D:1:AHS-90D) dated December 29, 1938, and as a basis of his proceeding alleges as follows:

1. The petitioner is a resident of Hubbard Woods, Illinois, and his residence address is 990 Sheridan Road, Hubbard Woods, Illinois. He filed his income tax returns for the years here involved with the Collector of Internal Revenue for the First District of Illinois.

2. The notice of deficiency, a copy of which is attached hereto and marked "Exhibit A", was mailed to the petitioner on December 29, 1938.

3. The taxes in controversy are income taxes for the years 1934 and 1935. The deficiencies claimed by the Commissioner are $14,054 for the year 1934 and $10,-
4 588.60 for the year 1935, of which approximately $12,000 for 1934 and $9,000 for 1935 are in dispute.

4. The determination of the deficiencies set forth in said notice is based upon the following error:

The determination by the Commissioner that the income of three trusts created by the petitioner for the benefit of his children was taxable to the petitioner under the provisions of Section 166 of the Revenue Act of 1934.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) On March 31, 1930, the petitioner, by three separate trust agreements, created three trusts for the benefit of his three children respectively. The trustees of each trust are the petitioner, his wife and his brother. Each trust agreement provides a life income for the child for whose benefit the trust was created and for a division of the principal on the death of the child among the issue of the child, with contingent gifts to other persons if there shall be no issue then living.

(b) There was and is no provision in said trusts under which the petitioner could ever receive any principal or income thereof. The petitioner did not retain the power to revest in himself title to any part of the principal of
5 the trusts.

(c) The petitioner wanted to have his children protected and, accordingly, provided in paragraph Ninth of each of the trust agreements that his wife and his brother, or the survivor, should have the right to amend the trust by changing the beneficiary, or by changing the time when income or principal should be payable, or in other respects, but there was no intention and no provision that they could modify the trust so as to revest in the petitioner title to any part of the principal of the trust. It was in fact specifically provided in paragraph Eighth of each trust that if the petitioner desired to exercise his right under the provisions of said paragraph to withdraw any property from the trust he could do so only upon first transferring to the trustees other property satisfactory to them, of a market value at least equal to that of the property so withdrawn. It was the intent of the trust agreements that no portion of principal could be revested in the petitioner by anyone without such substitution of other property satisfactory to the trustees and of at least equal value to the property withdrawn.

(d) The petitioner's wife and brother, who had power to modify the trust in the manner above stated, were also trustees and could not legally as trustees have revested any principal of the trusts in the petitioner except in
6 exchange for property of equal value which was satis-

factory to them. To remove any possible doubt as to this, and after a question had been raised as to the effect of provisions contained in Section 166 of the Revenue Act of 1934 which had not been contained in the corresponding section of the Revenue Act of 1928 in force when said trusts were created, the trust agreements were amended on August 3, 1935, by striking out said provisions of paragraphs Eighth and Ninth hereinabove described.

(e) In the audit of the petitioner's income tax returns for the years here in question the Commissioner included in petitioner's gross income the entire net income of said trusts for the year 1934 and for the period from January 1, 1935, to August 3, 1935, on the ground that such income was taxable to the petitioner under Section 166 of the Revenue Act of 1934, because of the alleged power in his wife and brother to revest the principal of the trusts in him.

(f) The petitioner avers that said trusts do not come within the provisions of Section 166 of the Revenue Act of 1934 and that the income of said trusts is not taxable to him under said statutory provisions.

Wherefore, your petitioner prays that the Board may hear this proceeding and redetermine the deficiencies
7 determined by the Commissioner.

Herbert Pope,
Benjamin M. Price,
Preston B. Kavanagh,
Counsel for Petitioner,
707 Munsey Building,
Washington, D. C.

8 State of Illinois, } ss.
County of Cook. }

John Stuart, being duly sworn, says that he is the petitioner above named; that he has read the foregoing petition and is familiar with the statements contained therein and that the facts stated therein are true.

John Stuart.

Subscribed and sworn to before me this 3rd day of March, 1939.

W. McKenzie Mothersill,
Notary Public.

(Notarial Seal)

9 EXHIBIT A.

December 29, 1938.

IT:R:D:1
AHS-90D

Mr. John Stuart,
990 Sheridan Road,
Hubbard Woods, Illinois.

Sir;

You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1934 and 1935 discloses a deficiency of $24,642.60 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C. for the attention of IT:C1:P-7. The signing and filing of this form will expedite the closing your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

Guy T. Helvering,
Commissioner,
By (Signed) John R. Kirk,
Deputy Commissioner.

Enclosures:
Statement
Form of waiver AHS/AMEN-2

10 Statement.

IT:R:D:1
AHS-90D

Mr. John Stuart,
990 Sheridan Road,
Hubbard Woods, Illinois.

Tax Liability for Taxable Years Ended December 31, 1934 and 1935.

Income tax.

Year	Liability	Assessed	Deficiency
1934	$ 70,685.72	$ 56,631.72	$14,054.00
1935	83,295.81	72,707.21	10,588.60
Totals	$153,981.53	$129,338.93	$24,642.60

In making this determination of your income tax liability, careful consideration has been given to the revenue agent's report dated February 17, 1937; to your protest dated March 30, 1937, and to the statements made at a conference held in this office with your representative.

A copy of this communication has been transmitted to your representative, Mr. P. B. Kavanagh, 707 Munsey Building, Washington, D. C., in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau.

1934.

Adjustments to Net Income.

Net income as disclosed by return		$157,257.45
Unallowable deductions and additional income:		
(a) Taxes disallowed	$ 1,747.79	
(b) Interest paid disallowed	1,944.84	
(c) Fiduciary income increased	22,560.02	26,252.65
Net income adjusted		$183,510.10

11 Explanation of Adjustments.

(a) and (b) Your proportionate share of taxes and interest paid by a cooperative building corporation have been disallowed as proper deductions on your return in accordance with United States Board of Tax Appeals decision published in Volume 27, page 530.

(c) You failed to report income from the trusts created for the benefit of your three children, John Stuart, Jr., Ellen S. Poole, and Joan Stuart Scudder. An examination of the trust agreements covering these tree trusts indicates that in each case your wife, Ellen Shunway Stuart, and your brother, R. Douglas Stuart, as trustees, have full power to sell, transfer, or assign any or all of the stocks, bonds, or securities held by the trustees under the trust agreement and to invest and reinvest the proceeds thereof. Paragraph 9 of the trust instruments provides that during your life the said Ellen Shunway Stuart and the said R. Douglas Stuart shall have full power and authority by an instrument in writing signed and delivered by them or by the survivor of them to the trustees, to alter, change, or amend the trust agreement at any time by changing the beneficiaries, or by changing the time when the trust fund or the income thereof is to be distributed, or by changing the trustees, or in any other respect. This paragraph remained in effect until August 3, 1935; hence this office is of the opinion that for the year 1934 these trusts were revocable trusts and, therefore, are taxable to you under the provisions of section 166 of the Revenue Act of 1934. This section provides that;

"Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—

• • • • •

"(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust shall be included in computing the net income of the grantor."

The trustees under your trust agreements have full power over the disposition of the corpus and do not constitute an adverse interest.

12 Computation of Tax.

Net income adjusted		$183,510.10
Less:		
Personal exemption		2,500.00
Balance (surtax net income)		$181,010.10
Less:		
Dividends	$172,720.55	
Earned income credit	1,400.00	174,120.55
Net income subject to normal tax		$ 6,889.55
Normal tax at 4% on $6,889.55		275.58
Surtax on $177,010.10 (Amount in excess of $4,000.00)		70,435.35
Total tax		$ 70,710.93
Less:		
Income tax paid at source		25.21
Correct income tax liability		$ 70,685.72
Income tax assessed:		
Original, account #200277		56,631.72
Deficiency of income tax		$ 14,054.00

1935.

Adjustments to Net Income.

Net income as disclosed by return		$185,534.77
Unallowable deductions and additional income:		
(a) Taxes disallowed	$ 796.44	
(b) Interest paid disallowed	1,945.44	
(c) Interest	1,247.30	
(d) Taxes	122.42	
(e) Fiduciary income	16,800.00	20,911.60
Total		$206,446.37
13 Nontaxable income and additional deductions:		
(f) Interest on tax-free covenant bonds		1,247.30
Net income adjusted		$205,199.07

Explanation of Adjustments.

(a) and (b) See explanation (a) and (b) for 1934.

(c) and (f) Interest received on the securities listed below has been transferred from tax-free covenant bond interest to ordinary interest, inasmuch as these bonds do not carry the tax-free covenant clause:

Indian Hill Country Club	$150.00
Asheville School	300.00
Continental Securities Co.	400.00
Chicago Daily News	291.80
Riding Club	18.00
Pinehurst, Inc.	60.00
General Baking Company	27.50
Total	$1,247.30

(d) Under taxes you claimed your proportionate share of the taxess on a boat house at Charlevoix. This boat house appears to be club property; hence you cannot be allowed a deduction on your income tax return for taxes paid on property which does not belong to you.

(e) As fully explained on page 2 the income from the three trusts created for the benefit of your children during the period that these trusts are revocable, namely, January 1 to August 3, 1935, is taxable to you under the provisions of section 166 of the Revenue Act of 1934.

Computation of Tax.

Net Income adjusted		$205,199.07
Less:		
Personal exemption		2,500.00
Balance (surtax net income)		$202,699.07
Less:		
Dividends	$167,841.40	
Earned income credit	1,400.00	169,241.40
Net income subject to normal tax		$ 33,457.67
Normal tax at 4% on $33,457.67		1,338.31
Surtax on $198,699.07 (Amount in excess of $4,000.00)		81,957.50
Total tax		83,295.81
Less:		
Income tax assessed, original, account #204522		72,707.21
Deficiency of income tax		$ 10,588.60

AHS/AME N-2

Filed May 2, 1939.

UNITED STATES BOARD OF TAX APPEALS.

(Caption—97500)

ANSWER.

Filed May 2, 1939.

The Commissioner of Internal Revenue by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition filed in the above-entitled appeal, admits, denies and alleges as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the petition herein.

3. Denies the allegations contained in paragraph 3 of the petition herein, except it is admitted that the taxes in controversy are income taxes for the years 1934 and 1935 and that the deficiencies claimed by the Commissioner are $14,054.00 for the year 1934, and $10,588.60 for the year 1935.

4. Denies that the respondent committed the error alleged in paragraph 4 of the petition herein.

5. (a) Denies the allegations contained in subparagraph (a) of paragraph 5 of the petition herein, except it is admitted that on March 31, 1930, the petitioner by certain trust agreements created three trusts for the benefit of his three children, respectively, and that the trustees of each trust are the petitioner, his wife and his brother.

(b), (c) and (d) Denies the material allegations of fact contained in subparagraphs (b), (c) and (d) of paragraph 5 of the petition herein.

(e) Denies the allegations contained in subparagraph (e) of paragraph 5 of the petition herein, except it is admitted that in the audit of the petitioner's income tax returns for the years here in question, the Commissioner included in petitioner's gross income the entire net income of said trusts for the year 1934 and for the period from January 1, 1935, to August 3, 1935, on the ground that such income was taxable to the petitioner under Section 166 of the Revenue Act of 1934.

(f) Denies the allegations contained in subparagraph (f) of paragraph 5 of the petition herein.

Denies generally and specifically each and every allega-

tion, contained in the petition not hereinbefore expressly admitted, qualified, or denied.

Wherefore, respondent prays that the Board redetermine the deficiency herein to be the amount determined by the Commissioner, viz.: $24,642.60.

(Signed) J. P. Wenchel,
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
F. R. Shearer,
Division Counsel.
D. A. Taylor,
Special Attorney, Bureau of Internal Revenue.

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17 UNITED STATES BOARD OF TAX APPEALS. Filed May 8, 1940.
(Caption—97500)

AMENDMENT TO ANSWER.

Filed May 8, 1940.

The Commissioner of Internal Revenue by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, pursuant to leave granted by the Board at the hearing of this case on May 6, 1940, to amend respondent's answer herein, for amendment to the respondent's answer herein alleges:

That the income of the trusts mentioned in the petition herein aggregating $22,560.02 for the calendar year 1934 and $16,800.00 for the period January 1, 1935, to August 3, 1935, included in the petitioner's gross income in the notice of deficiency involved herein under the provisions of Section 166 of the Revenue Act of 1934 is taxable also to the petitioner herein under Section 167 of the said Revenue Act for that the said income, in the discretion of persons not having a substantial adverse interest in the disposition of said income, may be held and accumulated for future distribution to the grantor; may be distributed to the grantor and may be applied to the payment of premiums upon policies of insurance on the life of the grantor.

Wherefore, respondent prays that the Board redetermine the deficiency herein to be the amount determined by the Commissioner, viz.: $24,642.60.

(Signed) J. P. Wenchel,
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
F. R. Shearer,
Division Counsel.
D. A. Taylor,
Special Attorney, Bureau of Internal Revenue.

Filed May 6, 1940.

UNITED STATES BOARD OF TAX APPEALS.

(Caption—97500)

STIPULATION OF FACTS.

Filed May 6, 1940.

It is hereby stipulated by and between the parties to the above entitled cause through their counsel that the following statements of facts may be received in evidence as true, without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated.

1. The petitioner resides at 990 Sheridan Road, Hubbard Woods, Illinois. He filed income tax returns for 1934 and 1935, the years here involved, with the Collector of Internal Revenue for the First District of Illinois.

2. The notice of the deficiency here involved was mailed to the petitioner on December 29, 1938. A true and correct copy of the notice is attached to the petition heretofore filed in this proceeding. By reference said notice is hereby made a part of this stipulation to the same effect as if it were incorporated herein.

3. On March 31, 1930, the petitioner executed an agreement, a true copy of which is attached hereto as Exhibit 1, creating a trust for the benefit of his daughter, Joan Stuart Scudder.

4. On the same date the petitioner executed another agreement creating a trust for the benefit of his daughter,

Ellen. The provisions of this agreement are identical with the provisions of the agreement mentioned in paragraph 3 hereof except for the designation of Ellen as beneficiary instead of Joan. Ellen was married in 1930 shortly after the creation of this trust and her married name is Ellen Stuart Poole.

5. On the same date the petitioner executed another agreement creating a trust for the benefit of his son, John. The provisions of this agreement are identical with the provisions of the agreement mentioned in paragraph 3 hereof except for the designation of John as beneficiary instead of Joan.

6. The net income of the petitioner, as shown by his income tax returns and not including any income of the trusts, was $157,257.45 in 1934 and $185,534.77 in 1935.

7. The birth dates and ages (at nearest birthday) of said children are as follows:

29	Joan	May 31, 1904	36 years
	Ellen	June 21, 1907	33 years
	John	January 1, 1912	28 years

Throughout 1934 and 1935 Joan and Ellen were married.

8. On August 3, 1935, Ellen Shumway Stuart, wife of the petitioner, and Robert Douglas Stuart, brother of the petitioner, executed an amendment of the agreement mentioned in paragraph 3 hereof. A true copy of said amendment is attached hereto as Exhibit 2. On the same date said Ellen Shumway Stuart and Robert Douglas Stuart executed an amendment of the agreement mentioned in paragraph 4 hereof and an amendment of the agreement mentioned in paragraph 5 hereof, and said amendments contain the same provisions in regard to the respective agreements to which they refer as are contained in said Exhibit 2 in regard to the agreement to which it refers.

9. For the calendar years 1934 and 1935 the amounts of the net income of said trusts and the amounts thereof distributed to the beneficiaries of said trusts were as follows:

	1934	1935
Trust for Joan		
Net Income	$7,496.74	$8,295.00
Distributed to her	7,496.74	7,675.36
Undistributed	None	619.64
Trust for Ellen		
Net Income	7,496.74	8,295.00
Distributed to her	7,496.74	7,473.80
Undistributed	None	821.20
Trust for John		
Net Income	7,566.54	9,135.00
Distributed to him	1,863.33	2,740.50
Undistributed	5,703.21	6,394.50

10. The total net income of said trusts for 1934 was $22,560.02, and the respondent has determined that said net income is to be included in the gross income of the petitioner in computing his income tax for said year.

11. The total net income of said trusts for 1935 was $25,725.00 of which $16,800.00 was received by the trusts during the period from January 1, 1935, to August 3, 1935. The respondent has determined that said amount of $16,800.00 of the net income of the trusts is to be included in the gross income of the petitioner in computing his income tax for 1935.

Herbert Pope,
Attorney for Petitioner.

J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent.

31 EXHIBIT 1.

This Indenture, made this 31st day of March, 1930, between John Stuart, of Winnetka, Cook County, Illinois (hereinafter called the Donor), party of the first part, and Ellen Shumway Stuart, of Winnetka, Cook County, Illinois, Robert Douglas Stuart, of Lake Forest, Lake County, Illinois, and John Stuart, the Donor (hereinafter called the Trustees), parties of the second part, Witnesseth:

First. The Donor has assigned, transferred and set over, and does hereby assign, transfer and set over unto the Trustees seven hundred (700) shares of common capital stock of The Quaker Oats Company (sometimes referred to herein as the "Trust Fund"), and the Trustees are hereby authorized and empowered to receive and accept any and all property which at any time and from time to time may be delivered, transferred or assigned to the Trustees to become a part of the principal of the Trust Fund, which, together with any income therefrom accumulated as hereinafter provided, is to be held and disposed of together with the proceeds thereof as hereinafter in this Indenture provided.

Second. The Trustees shall have power and authority to receive and collect all income from the Trust Fund, including dividends, interest and any and all sums at any time payable in respect of any shares of stocks, bonds, or
32 other securities or property forming a part of the Trust Fund; to sell, transfer and assign any or all of the stocks, bonds, securities or property held by the Trustees under this instrument, and to invest and reinvest the proceeds thereof and the net income derived therefrom, which shall not be distributed as hereinafter provided, in municipal or government bonds, stocks, real estate mortgages, or other income-producing property or securities, real or personal, within or without the State of Illinois without being limited or restricted to investments as fixed by the statutes of the State of Illinois, and to make, execute and deliver all necessary and proper assignments, conveyances, deeds and other instruments; to exercise the voting power upon all shares of stock held by the Trustees hereunder, and to exercise every power, election and discretion,

give every notice, make every demand, and do every act and thing in respect of any shares of stocks and bonds which they could or might do if they were absolute owners thereof; to unite with owners of similar property in carrying out any plan for the reorganization of any corporation or company, the securities of which form a portion of the Trust Fund; to exchange the securities of any corporation for others issued by the same or by any other corporation upon such terms as the Trustees shall deem proper; to assent to the consolidation or merger of such corpora-
33 tion; to pay such assessments, expenses and sums of money as they may deem expedient for the protection of the interest of the Trust Fund in stocks, bonds, or other securities of any corporation or company; and to employ such agents and attorneys as may be necessary. Any person dealing with the Trustees shall not be required to see to the application of any money or moneys paid to the Trustees.

Third. For the purpose of this Indenture, net income shall include interest, dividends and rents from the stocks, bonds, and other securities and property constituting the Trust Fund after making any and all deductions therefrom in this Indenture provided for or required by law. Stock dividends, liquidating dividends and proceeds from the sale of any part of the Trust Fund, including profits, if any, shall constitute principal.

Fourth. For and during a period of fifteen (15) years from the date of this Indenture, the Trustees shall pay over and distribute, in reasonable installments, to Joan Stuart Scudder, of Winnetka, Cook County, Illinois, daughter of the Donor, so much of the net income from the Trust Fund as they in their sole discretion shall deem advisable, the undistributed portion of such income to be added to and become a part of the principal of the Trust Fund. From and after the expiration of fifteen (15) years from the date of this Indenture, the Trustees shall pay
34 to said Joan Stuart Scudder, in reasonable installments, the entire net income from the Trust Fund for and during her life.

Fifth: Upon the death of said Joan Stuart Scudder, the Trustees shall pay over the principal of the Trust Fund to her issue then surviving, if any, per stirpes, and if she shall leave no issue then surviving, to the issue then surviving of the Donor, per stirpes. If upon the death of said

Joan Stuart Scudder, any beneficiary hereunder shall be a minor, then the Trustees shall apply so much of the income from the share of each such beneficiary for his or her support, maintenance and education as to the Trustees shall seem advisable, and in such manner as to them shall seem best, and free from the control of any guardian, until he or she shall arrive at his or her majority, when the Trustees shall pay over to each such beneficiary the unexpended income and the principal of his or her share of the Trust Fund. In case of the death of any such beneficiary before he or she shall become entitled to receive the principal of his or her share of the Trust Fund, the Trustees shall immediately pay over his or her share thereof to the issue then surviving of said Joan Stuart Scudder, per stirpes, and if she shall leave no issue then surviving to the issue then surviving of the Donor, per stirpes.

Sixth. If at the time of the death of said Joan Stuart Scudder there shall be surviving no issue either of
35 said Joan Stuart Scudder or of the Donor, then the Trustees shall pay over the principal of the Trust Fund in equal shares to Princeton University and the University of Chicago.

Seventh. The interests by this Indenture created in either principal or interest shall not be grantable, transferable or otherwise assignable by anticipation, either by voluntary or involuntary act of the beneficiary, or by operation of law, and the said interests, or any part thereof, shall in no way or manner be liable for or be liable to be taken for any debt, liability or contract of the beneficiary whenever created, or be applied in any way or any manner to the payment thereof, it being the intention of the Donor to assure the payment of the income during the terms specified, and the distribution of the principal as specified to the beneficiary for her own individual use and benefit, and to limit her rights hereunder to such sums only as may become payable to her as herein provided.

Eighth. The Donor reserves and shall have the right at any time and from time to time to direct the Trustees to sell the whole of the Trust Fund, or any part thereof, and to reinvest the proceeds in such other property as the Donor shall direct. The Donor further reserves and shall have the right at any time and from time to time to
36 withdraw and take over to himself the whole or any part of the Trust Fund upon first transferring and

delivering to the Trustees other property satisfactory to them of a market value at least equal to that of the property so withdrawn.

Ninth. During the life of the Donor, the said Ellen Shumway Stuart and the said Robert Douglas Stuart, or the survivor of them, shall have full power and authority, by an instrument in writing signed and delivered by them or by the survivor of them to the Trustees, to alter, change or amend this Indenture at any time and from time to time by changing the beneficiary hereunder, or by changing the time when the Trust Fund, or any part thereof, or the income, is to be distributed, or by changing the Trustees, or in any other respect.

Tenth. The Trustees shall incur no liability or responsibility with respect to the validity of this Indenture, or any provisions thereof, or on account of any loss to or diminution in value of the property which may at any time constitute or be included in the Trust Fund, or on account of any other matter whatsoever, except such as may be due to their, his, her, or its actual fraud or willful mismanagement. The Trustees shall have a lien upon the income and principal of the Trust Fund for the reimbursement of any and all costs, expenses, and liabilities which they may incur or suffer by reason of this Indenture.

37 Eleventh. The Trustees, or any of them, may resign at any time by giving notice in writing of such resignation to the Donor during his life, and after his death by giving notice in writing of such resignation to the beneficiary or beneficiaries hereunder. In case of the resignation of one of the Trustees, or of his or her disability or incapacity to act further as Trustee, the remaining two Trustees shall have all the rights, powers, duties and authority granted to or imposed upon all of the Trustees under the provisions of this Indenture. In case of the resignation, disability or incapacity to act further of two or of three of the Trustees, then The Northern Trust Company, a corporation having its principal place of business in Chicago, Illinois, or its successor, shall act as joint Trustee or as sole Trustee, as the case may be, with all of the rights, powers, duties and authority by this Indenture granted to or imposed upon an original Trustee, in case it shall act jointly, or granted to or imposed upon all the original Trustees, in case it shall act alone.

Twelfth. Wherever the word "Trustees" occurs herein,

it shall be taken and held to embrace the Trustees or the Trustee for the time being under this Indenture, whether original or successor.

Thirteenth. In case The Northern Trust Company shall act as a Trustee hereunder, it shall be entitled to receive reasonable compensation for its services.

38 Fourteenth. The Trustees hereby accept the Trust created by this Indenture upon and subject to the terms and conditions thereof.

Fifteenth. It is understood that this Indenture is made in the State of Illinois and governed by the laws thereof.

In Witness Whereof, the Donor and the Trustees have hereunto set their hands and seals.

John Stuart (Seal)

Donor.

Ellen Shumway Stuart (Seal)
Robert Douglas Stuart (Seal)
John Stuart (Seal)

Trustees.

39 **EXHIBIT 2.**

Amendment of Indenture Made the 31st Day of March, 1930, Between John Stuart, of Winnetka, Cook County, Illinois (Therein Called the Donor), Party of the First Part, and Ellen Shumway Stuart, of Winnetka, Cook County, Illinois, Robert Douglas Stuart, of Lake Forest, Lake County, Illinois, and John Stuart, the Donor (Therein Called the Trustees), Parties of the Second Part, for the Benefit of Joan Stuart Scudder, Daughter of the Donor.

Whereas, in the Ninth paragraph of the Indenture made the 31st day of March, 1930, between John Stuart, of Winnetka, Cook County, Illinois (therein called the Donor), party of the first part, and Ellen Shumway Stuart, of Winnetka, Cook County, Illinois, Robert Douglas Stuart, of Lake Forest, Lake County, Illinois, and John Stuart, the Donor (therein called the Trustees), parties of the second part, for the benefit of Joan Stuart Scudder, daughter of the Donor, it was provided as follows:

"Ninth: During the life of the Donor, the said Ellen Shumway Stuart and the said Robert Douglas Stuart, or

the survivor of them, shall have full power and authority, by an instrument in writing signed and delivered by them or by the survivor of them to the Trustees, to alter, change or amend this Indenture at any time and from time to time by changing the beneficiary hereunder, or by changing the time when the Trust Fund, or any part thereof, or the income, is to be distributed, or by changing the Trustees, or in any other respect."

Now, Therefore, the undersigned, the said Ellen Shumway Stuart and the said Robert Douglas Stuart, being the persons mentioned in said paragraph "Ninth," hereby alter, change and amend said Indenture as follows:

First. Paragraph "Eighth" of said Indenture and all of the provisions of said paragraph are hereby cancelled and expunged so that said Indenture shall henceforth be of the same effect as if said paragraph and the provisions thereof were not included therein.

Second. All of the provisions of said paragraph "Ninth" of said Indenture are hereby cancelled and expunged so that said Indenture shall henceforth be of the same effect as if the provisions of said paragraph were not included therein, and said paragraph "Ninth" is hereby changed and amended so that as changed and amended it shall read as follows:

Ninth: This Indenture and all of the provisions thereof are irrevocable and not subject to alteration, change or amendment.

In Witness Whereof, the undersigned have hereunto placed their hands and seals this 3rd day of August, 1935.

Ellen Shumway Stuart (Seal)
Robert Douglas Stuart (Seal)

The undersigned, as Trustees of the Trust created by the Indenture above described, hereby acknowledge the delivery to them of the foregoing Amendment to said Indenture.

Ellen Shumway Stuart
Robert Douglas Stuart
John Stuart

41 UNITED STATES BOARD OF TAX APPEALS.

• • (Caption—97500) • •

STATEMENT OF EVIDENCE FROM REPORTER'S MINUTES.

Filed May 29, 1941.

Hearing at Chicago, Illinois, on the 6th day of May, 1940, at 2:00 o'clock, P. M.

The above-entitled proceeding came on for hearing on Monday, the 6th day of May, 1940, before the Honorable Marion J. Harron, Member of the United States Board of Tax Appeals, at Chicago, Illinois, pursuant to notice of hearing heretofore given; whereupon, the following proceedings were had and testimony heard, to-wit:

EVIDENCE ON BEHALF OF PETITIONER.

Thereupon, the petitioner, to maintain the material averments of his petition, introduced the following proof:

MR. JOHN STUART, the petitioner herein, called as
42 a witness on his own behalf, having been first duly sworn, was examined and testified as follows:

The Clerk: Please take the stand and state for the record your full name.

The Witness: John Stuart.

Direct Examination by Mr. Pope.

Q. Your name is spelled S-t-u-a-r-t?
A. Yes.
Q. What is your residence, Mr. Stuart?
A. Hubbard Woods, Illinois.
Q. And what is your occupation?
A. Milling business.
Q. What is the company that you are associated with?
A. Quaker Oats Company.
Q. What is your position with the Quaker Oats Company?

A. President.

Q. You are married and, under the stipulation, have three children?

A. Yes.

Q. They are still living?

A. Yes.

Q. In March, 1930, how old were the children at that time, approximately? The oldest one was Joan.

A. She was about 26.

43 Q. Was she married?

A. Yes.

Q. Ellen was the second child?

A. Yes.

Q. Was she married at that time?

A. No.

Q. Was she married shortly afterwards?

A. She was married in May of 1930.

Q. And the trust was made in March, March 31st?

A. I think so.

Q. The son, John Stuart, was how old?

A. About 18.

Q. Had you made provision for the children prior to the time that you created this trust in 1930?

A. You mean in the way of allowances?

Q. Well, allowances, or had you made any permanent provision prior to that time for them?

A. No.

Q. The provision made in these trusts was the first provision of that character that you had made for any of the children?

A. That's right.

Q. What was your reason for making a trust at that time?

Mr. Taylor: I object, your Honor. It seems to me that the reason for making the instrument is purely immaterial and irrelevant.

44 The Member: I will overrule the objection.

Mr. Taylor: May I have an exception?

The Member: Yes, you may.

You may answer.

A. My reason for creating the trusts at that time was due to the fact that Joan, the older girl, was married the previous fall. The younger girl was about to be married.

I had been giving each of the children an allowance.

I felt, and their mother agreed with me, that when they were married, as far as it was possible, we ought to make them independent to the extent that they could run their homes in a reasonable way.

Personally, I always have been, and was at that time, very much opposed to having the children, or the girls, on what I considered a remittance plan, which an allowance is.

Mr. Taylor: May I have an understanding that my objection to this line of testimony may be shown of record without repeating my objection?

The Member: Yes. I understand that your objection is that this testimony is not strictly material?

Mr. Taylor: It is not material or relevant.

The Member: That the trust instrument speaks for itself. I understand the objection is all the way through.

You may continue.

The Witness: It was for that reason that we created the trusts. The question of trustees—do you want me to go on and tell this?

45 The Member: No. I think you have answered that question that was asked.

By Mr. Pope:

Q. What was your idea with reference to the appointment of trustees under this trust, and the reason for providing that your wife and your brother, who were two of the trustees, should have discretionary powers with reference to modifying the trust?

Mr. Taylor: If your Honor please, we are getting close to an attempt to modify the provisions of the trust in that question. Of course, that is incompetent as well as being immaterial and irrelevant.

The Member: The objection to the testimony is that it goes to the explaining of the provisions of this trust and is immaterial. I am going to overrule that objection with the understanding, of course, that I shall have to weigh this testimony.

I think that some of it may be immaterial, but I don't want to interfere at this time with the plan of the counsel for the petitioner in presenting his case. The trust instrument speaks for itself. That, of course, is understood anyway.

Do you want the reporter to read the question?

Mr. Taylor: If your Honor please, may I be indulged just another moment? I gather from your Honor's remark

that it is a question of materiality, but it is not altogether a question of materiality. It is a question of competency, as well, insofar as the testimony undertakes to vary the terms of a trust instrument. In other words, if the
46 trust instrument is unambiguous on its face, and we must look to the face of the instrument alone in order to determine any ambiguity, any testimony which undertakes to explain or to extend or to take from the provisions of the trust is incompetent. That is a rule of evidence that is, I think, well established.

Mr. Pope: We are not attempting—I beg your pardon.

The Member: That clarifies your objection, Mr. Taylor, and if this testimony goes beyond a certain point and becomes entirely incompetent, I shall have to rule that it be stricken from the record, but I think we will have to wait and see how far the testimony goes.

I take it you want an exception?

Mr. Taylor: Yes, I want an exception to your ruling. I had understood his question to include some inquiry about the meaning of those provisions, and that is the reason I at that time made a part of my objection the matter of the competency.

Mr. Pope: My object is not to vary the instrument in any way, or to explain the terms, but simply to bring out facts with reference to the situation as it existed at that time, and in these cases, as your Honor knows, a great deal turns out on the reason for having members of the family trustees as compared with having a corporation as trustee.

In view of the provisions of the trust, I was merely asking the petitioner to explain the circumstances and reasons for having these particular persons as trustees.

47. The Member: Will the reporter read the question?

(Whereupon, the reported read the question as recorded as follows:

"Q. What was your idea with reference to the appointment of trustees under this trust, and the reason for providing that your wife and your brother, who were two of the trustees, should have discretionary powers with reference to modifying the trust?")

The Witness: All right?

The Member: Yes.

A. My reason for appointing my brother and my wife as trustees was that I knew they had the same point of view in regard to the children, their needs, and how they wanted

them to live, that I did. I knew they would be just as hard-boiled in dealing with them as I would.

I thought, on the basis of that belief, that their interests would be just as well protected and better served by having them instead of a corporate trustee. In addition to that, there was some saving, provided they functioned in that way.

The Member: You mean saving in—

The Witness: Cost.

The Member: In cost.

The Witness: In addition, I believed they would be just as hard-boiled with me as they would be with the children. They knew why the trusts were created. It was entirely done for the benefit of the children, and I felt sure they would resist any attempt by anyone to change that objective.

48 By Mr. Pope:

Q. Can you state what proportion, or what the relation of the amount of the principal that went into these three trusts in 1930 was as compared with your total net worth, approximately, at that time?

Mr. Taylor: I object to that, your Honor. It seems to me that testimony of what his net worth was and what the value of these securities was would be competent testimony by people competent to testify as to values, and so forth.

The Member: I think the petitioner is competent to testify to his own net worth. I will overrule the objection.

Mr. Taylor: The question was as compared with the value of the property going into these trusts.

The Member: I understand. The question is general. I overrule the objection.

Mr. Taylor: Exception, please.

The Member: The exception may be noted.

A. I don't think I can answer that question. I remember that it represented about a sixth of my income. That was the income from the trust as of that date, that is, the principal.

The Member: I don't think that answers the question.

By Mr. Pope:

Q. No, my question was whether or not, with reference to not the income, but the value of your property or estate as you estimated it at that time, how it compared with the principal that was in that trust.

49 Can you give a minimum figure as to your net worth at that time outside of the property in the trust?

A. Well, at the then values, something over 4 million.

Mr. Pope: That is all right.

The Member: What was the then value of the property you put in the trust?

The Witness: Let me see, now.

The Member: There are three trusts, are there?

Mr. Pope: Yes.

The Member: Can you tell that?

The Witness: 2,100 shares—

The Member: What is the principal amount of the three trusts?

Mr. Pope: 2,100 shares.

The Witness: And I think the market then was about $275. About 575,000.

Mr. Pope: All right. That is all.

Cross-Examination by Mr. Taylor.

Q. You are just trying to multiply the number of shares by your recollection that 275 was the value per share at that time?

A. Yes, sir.

Mr. Taylor: No cross-examination.

Witness excused.

Mr. Taylor: If your Honor please, at this time I would like to move to strike the testimony of this witness as being immaterial, irrelevant, and incompetent.

The Member: I overrule the objection, Mr. Taylor.

Mr. Taylor: Exception.

The Member: An exception will be noted.

Mr. Pope: That is all, if the Court please.

The Member: Has counsel for the respondent any witnesses?

Mr. Taylor: No, the respondent rests, if the petitioner has rested.

Mr. Pope: What shall we do about briefs?

The Member: The Clerk will read the dates.

The Clerk: Under the rules, the first briefs will be due June 20th for the original briefs, and July 5th for the reply briefs.

The Member: That concludes the hearing in Docket No. 97500, John Stuart.

Herbert Pope,
Attorney for Petitioner.

Agreed to:
(S) J. P. Wenchel.

19 UNITED STATES BOARD OF TAX APPEALS. Filed Nov. 29, 1940.

* * (Caption—97500) * *

Herbert Pope, Esq., Preston B. Kavanagh, Esq., and Benjamin M. Price, Esq., for the petitioner.

D. A. Taylor, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION.

HARRON: Respondent determined deficiencies of $14,054 and $10,588.60 in income tax for the years 1934 and 1935, respectively. The basic question is whether petitioner was taxable, in 1934 and in the first seven months of 1935, on the entire net income of three trusts which he created for the benefit of his three children. Other adjustments which respondent has made to the income reported by petitioner in his income tax returns for the years 1934 and 1935 are not contested.

Findings of Fact.

Petitioner is a resident of Hubbard Woods, Illinois, and filed his income tax return for each of the years 1934 and 1935 with the collector of internal revenue for the first district of Illinois.

20 Petitioner and his wife, Ellen Shumway Stuart, have three children: Joan, born May 31, 1904; Ellen, born June 21, 1907; and John, born January 1, 1912.

On March 31, 1930, petitioner executed three trust indentures by which he created three separate trusts, one for the benefit of each of his three children, and named himself, his wife, and his brother, Robert Douglas Stuart, as the trustees of each trust. To to the trustees of each trust petitioner transferred 700 shares of the common stock of the Quaker Oats Company, of which petitioner was president.

The provisions of each of the three trust indentures were substantially the same. For a period of fifteen years the trustees were to pay over to the child designated as the beneficiary of the particular trust "so much of the net

income from the Trust Fund as they in their sole discretion shall deem advisable" and to add the undistributed portion of the net income to the corpus of the trust. After fifteen years the trustees were to pay the entire net income from the trust to the beneficiary for life.

Upon the death of the beneficiary, the trustees were to pay over the principal of the trust to the beneficiary's issue then surviving or, if the beneficiary left no issue then surviving, to the issue then surviving of the petitioner; or, if there were surviving no issue of the beneficiary or of petitioner, to Princeton University and the University of Chicago in equal shares.

The trustees were empowered to collect all income; to sell any of the securities held in trust; to invest the proceeds from the sale of securities and the net income added to trust principal in "municipal or government bonds,
21 stocks, real estate mortgages, or other income-producing property or securities, real or personal, • • • without being limited or restricted to investments as fixed by the statutes of the State of Illinois"; to execute all necessary "assignments, conveyances, deeds and other instruments"; to exercise the voting power upon all shares of stock held in trust; and to exercise "every power, election and discretion, give every notice, make every demand, and do every act and thing in respect of any shares of stocks and bonds which they could or might do if they were absolute owners thereof"; to unite with others "in carrying out any plan for the reorganization of any corporation", the securities of which were held in trust; to exchange the securities of any corporation for others issued by any corporation; to assent to the consolidation or merger of any corporation; to pay "such assessments, expenses and sums of money as they may deem expedient for the protection of the interest" of the trust in the securities of any corporation; and to employ "such agents and attorneys as may be necessary."

Stock dividends, liquidating dividends and "proceeds from the sale of any part of the Trust Funds, including profits", were to constitute principal.

Each trust indenture contained a clause providing that the trustees were not to incur any liability "except such as may be due to • • • actual fraud or willful mismanagement", and a clause providing that any person dealing

with the trustees was not to be required "to see to the application of any money or monies paid to the Trustees."

22 Paragraphs Eighth and Ninth of each trust indenture provided as follows:

Eighth. The Donor reserves and shall have the right at any time and from time to time to direct the Trustees to sell the whole of the Trust Fund, or any part thereof, and to reinvest the proceeds in such other property as the Donor shall direct. The Donor further reserves and shall have the right at any time and from time to time to withdraw and take over to himself the whole or any part of the Trust Fund upon first transferring and delivering to the Trustees other property satisfactory to them of a market value at least equal to that of the property so withdrawn.

Ninth. During the life of the Donor, the said Ellen Shumway Stuart and the said Robert Douglas Stuart, or the survivor of them, shall have full power and authority, by an instrument in writing signed and delivered by them or by the survivor of them to the Trustees, to alter, change or amend this Indenture at any time and from time to time by changing the beneficiary hereunder, or by changing the time when the Trust Fund, or any part thereof, or the income, is to be distributed, or by changing the Trustees, or in any other respect.

On August 3, 1935, Ellen Sumway Stuart, petitioner's wife, and Robert Douglas Stuart, petitioner's brother, executed an amendment to each of the three trust indentures, canceling paragraph Eighth and changing paragraph Ninth to read as follows:

Ninth. This Indenture and all of the provisions thereof are irrevocable and not subject to alteration, change or amendment.

The net income of each of the three trusts in 1934 and 1935 was as follows:

Trust for	1934	1935
Joan	$ 7,496.74	$ 8,295.00
Ellen	7,496.74	8,295.00
John	7,566.54	9,135.00
Total	$22,560.02	$25,725.00

Of the total amount of the net income of the three trusts for 1935 $16,800 was received by the trustees during
23 the period from January 1, 1935, to August 3, 1935.

In 1934 and 1935 the net income of the three trusts was distributed to the beneficiaries thereof as follows:

Trust for	1934	1935
Joan	$7,496.74	$7,675.36
Ellen	7,496.74	7,473.80
John	1,363.35	2,740.50

In 1934 and 1935 Joan and Ellen were married.

Petitioner's net income (not including any income of the three trusts) was $167,257.45 in 1934 and $185,334.77 in 1935. At the time of the creation of the three trusts, petitioner's net worth was in excess of $4,000,000, and the property which he transferred to the trusts had a value of approximately $575,000.

Opinion.

The basic question is whether petitioner was taxable, in 1934 and in the first seven months of 1935, on the entire net income of the three trusts which he created for the benefit of his three children.

In computing the deficiencies in petitioner's income tax for 1934 and 1935, respondent included in petitioner's taxable income the entire net income of the three trusts during 1934 and during the period from January 1, 1935 to August 3, 1935, on which date the trust indentures were amended to provide that they were "irrevocable and not subject to alteration, change or amendment." In the deficiency notice respondent based his determination on section 166 (2) of the Revenue Act of 1934, the pertinent
24 provisions of which are set forth in the margin.[1] In an amended answer and in his brief respondent sup-

1. Sec. 166. Revocable Trusts.
Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—

* * * * * *

(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust shall be included in computing the net income of the grantor.

ports his determinations under section 167 (a) of the Revenue Act of 1934, the pertinent provisions of which are set forth in the margin,[2] as well as under section 166 (2).

The basic question and the underlying facts in this proceeding are admittedly similar to those in the proceeding brought by petitioner's brother, R. Douglas Stuart, Docket No. 97501, which was heard immediately after this proceeding was heard. The provisions of the trust indentures involved in the two proceedings are substantially identical, and the arguments made by the parties under sections 166 (2) and 167 (a) are substantially the same in both proceedings.

Therefore, the decision in this proceeding is controlled by the decision in *R. Douglas Stuart*, 42 B. T. A. ....., promulgated this day. In the *R. Douglas Stuart* case the Board held that the taxpayer's wife and brother (the present petitioner) had the power to revest in the taxpayer title to the corpora of four trusts created by the taxpayer because they were given absolute powers to amend the trust indentures under paragraph Ninth thereof, the provisions of which were identical with the provisions of paragraph Ninth of the present trust indentures; that the taxpayer's wife and brother, who were not beneficiaries of the trusts, did not have substantial adverse interests in the disposition of the corpora of the trusts or the income therefrom; and that, therefore, the taxpayer was taxable under section 166 (2) of the Revenue Act of 1934 on the entire net income of the trusts during 1934 and during the period from January 1, 1935 to August 2, 1935, the date on which the trust indentures were amended to provide that they were "irrevocable and not subject to alteration, change or amendment."

On the grounds set forth in *R. Douglas Stuart*, *supra*, it

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2. Sec. 167. Income for Benefit of Grantor.

(a) Where any part of the income of a trust—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor * * *;

then such part of the income of the trust shall be included in computing the net income of the grantor.

is held that petitioner is taxable on the entire income of the three trusts, which he created for the benefit of his three children, during 1934 and during the period from January 1, 1935, to August 3, 1935, under section 166 (2) of the Revenue Act of 1934. *Mulham* v. *Commissioner*, 110 Fed. (2) 916. In view of this conclusion it is not necessary to consider the further contentions made by respondent to the effect that petitioner is also taxable on the entire net income of the trusts during the period in question under section 167 (a) of the Revenue Act of 1934.

Decision will be entered under Rule 50.

Entered Nov. 29, 1940.

Entered Jan. 10, 1941.

26 UNITED STATES BOARD OF TAX APPEALS.

* * (Caption—97500) * *

DECISION.

Pursuant to the determination of the Board, as set forth in its Memorandum Findings of Fact and Opinion entered November 29, 1940, and in accordance with the recomputation under Rule 50 of the petitioner's income tax liability filed by the respondent December 16, 1940, in which counsel for petitioner has acquiesced, it is

Ordered and Decided: That there are deficiencies in income tax as follows: for the year 1934 there is a deficiency of $14,054, and for the year 1935 there is a deficiency of $10,588.60.

(s) Marion J. Harron,
Member.

(Seal)

Entered January 10, 1941.

Filed Apr. 3, 1941.

51 UNITED STATES BOARD OF TAX APPEALS.

* * (Caption—97500) * *

PETITION FOR REVIEW AND STATEMENT OF POINTS.

Filed April 3, 1941.

The above named petitioner, by his attorneys, hereby filed this petition for a review of the decision of the United States Board of Tax Appeals entered on January 10, 1941,

in the above entitled cause, together with his statement of points.

1. The taxable years involved are the calendar years 1934 and 1935.

2. The petitioner filed his income tax return for each of said years with the Collector of Internal Revenue at Chicago, Illinois.

3. The petitioner seeks review of said decision of the United States Board of Tax Appeals by the United States Circuit Court of Appeals for the Seventh Circuit.

52 Statement of Points.

4. In seeking such review the petitioner files this his statement of points:

(1) The Board of Tax Appeals erred in holding that the income of the three trusts involved in this case was taxable to the petitioner under the provisions of section 166(2) of the Revenue Act of 1934.

(2) Under the evidence in this case the Board of Tax Appeals erred in concluding that power was vested in the petitioner's wife and brother, who were trustees of the trusts, to revest the principal of the trusts in the petitioner, who was the grantor and not a beneficiary of the trusts.

(3) The conclusion of the Board of Tax Appeals as to the unlimited power of the petitioner's wife and brother defeats the tax in this case. If the petitioner's wife and brother had the power, as the Board held, to revest the principal of the trusts in the petitioner, then the Board erred in failing to hold that the income of the trusts was not taxable to the petitioner under section 166(2) of the Revenue Act of 1934 because the petitioner's wife and brother had a substantial adverse interest to such revesting of principal in the petitioner in that they had an unlimited power to modify the trusts and accordingly could cause income or principal to be paid to themselves.

53 (4) The Board of Tax Appeals erred in holding that there is a deficiency in income tax owing by the petitioner for the year 1934 in the amount of $14,054 and for the year 1935 in the amount of $10,588.60.

(5) The decision of the Board of Tax Appeals is not supported by any substantial evidence and is contrary to the evidence.

Wherefore, the petitioner prays that the said decision of the United States Board of Tax Appeals be reviewed and

reversed and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected.

Herbert Pope,
Herbert Pope,
Benjamin M. Price,
Benjamin M. Price,
Preston B. Kavanagh,
Preston B. Kavanagh,
Attorneys for Petitioner,
120 South Salle Street,
Chicago, Illinois.

Filed Apr. 5, 1941.

54 IN THE UNITED STATES CIRCUIT COURT OF APPEALS

For the Seventh Circuit.

John Stuart, *Petitioner on Review,* vs. Commissioner of Internal Revenue, *Respondent on Review.*	B. T. A. Docket No. 97500.

NOTICE OF FILING PETITION FOR REVIEW AND STATEMENT OF POINTS.

Filed April 5, 1941.

To: J. P. Wenchel, Chief Counsel,
Bureau of Internal Revenue.

You are hereby notified that John Stuart did, on the 3rd day of April, 1941, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Seventh Circuit, of the decision of the Board heretofore rendered in the above entitled case. Copies of the petition for review and the statement of points as filed are hereto attached and served upon you.

Daied this 3rd day of April, 1941.

(S) B. D. Gamble,
B. D. Gamble,
Clerk, U. S. Board of Tax Appeals.

Service of copy of Petition for Review and Statement of Points acknowledged this 5th day of April, 1941.

J. P. Wenchel,
C. A. R.

55 UNITED STATES BOARD OF TAX APPEALS. Filed May 29, 1941.

John Stuart, *Petitioner,*
vs.
Commissioner of Internal Revenue, *Respondent.*
} Docket No. 97500.

PRAECIPE FOR RECORD.

Filed May 29, 1941.

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Seventh Circuit copies duly certified as correct of the following documents and records in the above entitled cause in connection with the petition for review by the said Circuit Court of Appeals for the Seventh Circuit heretofore filed by the petitioner:

1. Docket entries of the proceedings before the Board in this case.
2. Pleadings before the Board in this case:
(a) Petition.
(b) Answer to petition.
(c) Amendment to answer.
3. Memorandum findings of fact and opinion of the Board, promulgated November 29, 1940.

56 4. Decision of the Board entered January 10, 1941.

5. Petition for review and statement of points, with proof of service.

6. Stipulation of facts, including exhibits, filed May 6, 1940.

7. The agreed statement of evidence, being portion of official report of hearing in this case on May 6, 1940, commencing on page 14 thereof with "Evidence on Behalf of Petitioner" and continuing to end of report on page 23.

8. This praecipe.

Herbert Pope,
Attorney for Petitioner.

Agreed to:
(S) J. P. Wenchel.

57 UNITED STATES BOARD OF TAX APPEALS.
• • (Caption—97500) • •

CERTIFICATE.

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 56, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 5th day of June, 1941.

B. D. Gamble,
(Seal) *Clerk, United States Board of Tax Appeals.*

Entered May 6, 1941. 58 UNITED STATES BOARD OF TAX APPEALS.
• • (Caption—97500) • •

ORDER ENLARGING TIME.

On motion of counsel for petitioner and consent of counsel for the respondent, it is

Ordered that the time for preparation of the evidence and for transmission and delivery of the record sur petition for review of the above entitled proceeding in the United States Circuit Court of Appeals for the Seventh Circuit be and it is hereby extended to June 12, 1941.

(Signed) C. R. Arundell,
Member.

Dated: Washington, D. C.
May 6, 1941.

s

Now, June 5, 1941, the foregoing is certified from the record as a true copy.

B. D. Gamble,
B. D. Gamble,
(Seal). *Clerk, U. S. Board of Tax Appeals.*

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

I, Kenneth J. Carrick, Clerk of the United States Circuit Court of Appeals for the Seventh Circuit, do hereby certify that the foregoing printed pages contain a true copy of the printed record, printed under my supervision and filed on the eleventh day of July, 1941, in the following cause: Cause No. 7695, John Stuart v. Commissioner of Internal Revenue, respondent, as the same remains upon the files and records of the United States Circuit Court of Appeals for the Seventh Circuit.

In testimony whereof, I hereunto subscribe my name and affix the seal of said United States Circuit Court of Appeals for the Seventh Circuit, at the City of Chicago, this thirteenth day of February A. D. 1942.

[SEAL]

KENNETH J. CARRICK,
Clerk of the United States Circuit Court of Appeals for the Seventh Circuit.

At a regular term of the United States Circuit Court of Appeals for the Seventh Circuit held in the City of Chicago and begun on the first day of October in the year of our Lord one thousand nine hundred and forty, and of our Independence the one hundred and sixty-fifth.

7695

JOHN STUART, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for Review of Decision of the United States Board of Tax Appeals

And, to-wit: On the nineteenth day of December, 1941, there was filed in the office of the Clerk of this Court, the opinion of the Court, which said opinion is in the words and figures following, to-wit:

In the United States Circuit Court of Appeals for the Seventh Circuit

October Term and Session, 1941

No. 7695

JOHN STUART, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

No. 7696

R. DOUGLAS STUART, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petitions for Review of Decisions of the United States Board of Tax Appeals

December 19, 1941

Before SPARKS, MAJOR and MINTON, Circuit Judges.

SPARKS, Circuit Judge. These petitions seek to review decisions of the United States Board of Tax Appeals. We shall treat them in the order of their numbers.

In the case of John Stuart, the Commissioner determined income tax deficiencies against him for the years 1934 and 1935. The Board confirmed that ruling and held that under Section 166 (2) of the Revenue Act of 1934, petitioner was taxable on the net income of three trusts which he had created in 1930 for the benefit of his three children.

The evidence comprised a stipulation of facts and petitioner's testimony, which substantially is as follows:

On March 31, 1930, petitioner executed three trust agreements, one for his daughter Joan, who had just been married; one for another daughter, Ellen, who was about to be and is now married; and one for his son, John. In 1934 all three children were over twenty-one years of age.

Petitioner created the trusts because he felt that the daughters ought to be made independent so that they could conduct their homes in a reasonable manner. He had been giving his children allowances, a plan which he did not approve, particularly after marriage. He appointed his wife, Ellen Shumway Stuart, his brother Robert Douglas Stuart, and himself as trustees of each

trust. His reason for appointing his wife and brother was that he knew that they shared his point of view in regard to the children, their needs, and how he wanted them to live, and that they would be just as strict in dealing with the children as he would be. He thought the children's interests would be better served and protected by having them as trustees than by having a corporate trustee. They knew that the trusts were created entirely for the benefit of the children, and the petitioner felt sure that as trustees they would resist any attempt by anyone to change that objective.

Petitioner's net worth, at the time the trusts were created, exceeded $4,000,000 exclusive of the trust property which was worth about $575,000. Each trust made the same provision for each child and each comprised 700 shares of common stock of the Quaker Oats Company, of which petitioner was president.

For the first fifteen years the trustees were to pay to the child designated as the beneficiary of the particular trust so much of the net income as in the discretion of the trustees they should deem advisable, and they were directed to add any undistributed income to the principal of the trust. After fifteen years the trustees were to pay the entire net income to such child. Upon the death of a child the trustees were to pay the principal of the trust to that child's issue then living, or, if there were no such issue, then to the issue of the petitioner then living, or, if there were no such issue then living, then in equal shares to Princeton University and the University of Chicago. The trustees were given the usual broad powers of management and administration. There was a spendthrift clause, a clause exonerating the trustees from liability except for fraud or willful mismanagement, a provision appointing a trust company as a co-trustee if two of the trustees should resign, and a provision that the trust should be governed by the laws of the State of Illinois.

The eighth and ninth articles of each indenture provided as follows:

"Eighth. The Donor reserves and shall have the right at any time and from time to time to direct the Trustees to sell the whole of the Trust Fund, or any part thereof, and to reinvest the proceeds in such other property as the Donor shall direct. The Donor further reserves and shall have the right at any time and from time to time to withdraw and take over to himself the whole or any part of the Trust Fund upon first transferring and delivering to the Trustees other property satisfactory to them of a market value at least equal to that of the property so withdrawn.

"Ninth. During the life of the Donor, the said Ellen Shumway Stuart and the said Robert Douglas Stuart, or the survivor

of them, shall have full power and authority, by an instrument in writing signed and delivered by them or by the survivor of them to the Trustees, to alter, change or amend this Indenture at any time and from time to time by changing the beneficiary hereunder, or by changing the time when the Trust Fund, or any part thereof, or the income, is to be distributed, or by changing the Trustees, or in any other respect."

On August 3, 1935, taxpayer's wife and brother above named, executed an amendment to each of the three trust indentures cancelling the eighth article and changing the ninth to read as follows:

"Ninth. This Indenture and all of the provisions thereof are irrevocable and not subject to alteration, change or amendment."

The total net income of the three trusts for 1934 was $22,560.02. Of this, Joan and Ellen each received the full shares of $7,496.74. There was distributed to John for that year $1,863.33, and there remained in his trust an undistributed amount of $5,703.21. For 1935 there was a total net income of the trusts of $25,725. Of this, the trusts of Joan and Ellen were each entitled to $8,295, and John's trust was entitled to $9,135. There was a partial distribution which left undistributed balances of income for this year due the trusts in the order named, the respective sums of $619.64; $821.20; and $6,394.50.

The Commissioner determined that the net income from each of the three trusts for 1934, and from January 1, 1935, to August 3, 1935, the date of the amendment, was taxable to the taxpayer, and upon that basis determined the deficiency. The Board sustained the Commissioner.

The Commissioner, in support of the Board's ruling, relies upon Section 166 of the Revenue Act of 1934, the material part of which reads as follows:

"Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested

* * * * *

"(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom,

"then the income of such part of the trust shall be included in computing the net income of the grantor."

Under this section the Commissioner contends that the terms of each indenture require the conclusion that there were no fiduciary restrictions upon the power of the taxpayer's wife and brother to revest the corpus of each trust in the taxpayer. Furthermore, he contends that the taxpayer's wife and brother had no interests in the property which were substantially adverse to

those of the taxpayer, and this he asserts to be true in view of family and business relationships, and the existence of an identical power in the taxpayer and his brother's wife with respect to trusts executed by his brother for the benefit of his own children.

The Commissioner bases his argument upon the premise that "if there is any possibility that the grantor (John Stuart) might become revested with the corpus of the trust the income is taxable to him." He asserts that this premise is contained in Treasury Regulations 86 under section 167 ("which provides for the taxation of the income of a trust to the grantor if he has retained an interest in the income thereof"), and that this regulation should be applied to section 166 which complements section 167. He further states that the test contained in his premise has been unanimously applied to section 167 by all the Circuit Courts of Appeal to which the question has been presented, including this court. See Graff v. Commissioner, 117 F. 2d 247. All the cases cited support the treasury regulation. However, none of them support the Commissioner's premise, because it is not supported either by the regulation or the Statute. The key thought of the Commissioner's premise is merely the *possibility* of *reinvestiture*. The "single test" of the regulation for section 166, is "whether the grantor has failed to *divest himself* * * * of every right which might by any possibility enable *him* once more to possess and *enjoy in title* the trust corpus." [Our emphasis.] It is only in case the grantor has retained any such interest that he is taxable with respect to the income of the trust. His reinvestiture must be based on some right which he has retained *ab initio*.

In the instrument before us, the grantor neither reserved nor retained any right which might by any possibility *enable him* to repossess or enjoy in title the trust property. True, in article eight he reserved the right at any time and from time to time to withdraw and take over to himself the whole or any part of the trust fund, but before doing so he must transfer and deliver to the trustees other property satisfactory to them, of a market value at least equal to that of the property so withdrawn. It is not denied that this provision was inserted to preserve to the trust the benefit of the grantor's vast knowledge and experience, and yet any such shifting or trading of investments must first be approved by the other trustees, and in no other respect was their power to invest or reinvest disturbed. This of course was a retention of a right, although not an exclusive one, yet it was not such a right as could by any possibility enable the grantor to possess and enjoy in title the trust corpus. It was merely the

right to make an offer to exchange securities which could not be enforced by the grantor without the consent of the other trustees.

The Commissioner contends, however, that John Stuart's right to recapture the corpora of these trusts is found in the exercise of the other trustees' discretion, as set forth in the original ninth article. He does not contend that this is either a legal, an equitable, or a moral right which the grantor could enforce, but he insists that because of the cross relationship between the grantor and his brother, R. Douglas Stuart, a trustee, the latter would be amenable to the wishes of the grantor. This cross relationship, aside from consanguinity and business relations, also contemplates the fact that almost two years subsequent to the declaration of the John Stuart trusts, his brother R. Douglas Stuart, declared a trust primarily for the benefit of his children in which he had named himself and his wife and petitioner as the trustees with substantially the same powers as those given to the trustees in the John Stuart trusts. Likewise the Commissioner insists that because of the marital relation between petitioner and his wife, she would be amenable to his wishes even to the point of depriving her own children of their rightful and perhaps needed allowance. Assuming without admitting such effect of these cross relationships as a legal conclusion, we submit that under such circumstances the recapture of the corpora of the trusts by petitioner would be by virtue of the future exercise of his influence over the other trustees and not by virtue of any right which he reserved or failed to grant at the time of his declaration, which is the "single test" promulgated by the Treasury Regulation.

We are not dealing here with technical considerations, niceties of the law, or the legal paraphernalia which inventive genius has constructed as a refuge from surtaxes. There is no inventive genius here; it is all quite old in the art. Congress, long ago and quite clearly, described the issue, and the Treasury Department, in unambiguous language, promulgated a regulation which laid down just one test for us to follow in determining the taxpayer's liability, if any.

The basic question then is whether the grantor by his original declaration "failed to divest himself * * * of every right which might by any possibility enable him once more to possess and enjoy in title the trust corpus." If he failed to do so he can not prevail here. If he did not thus fail he should prevail, even though as a result, his surtaxes may have been minimized. We fully appreciate that nothing should obscure this basic issue, and we feel assured that the mere decrease in the amount of the grantor's surtaxes is not sufficient to authorize us to alter the

plain words of the Statute and the Treasury Regulations under the guise of judicial construction. To lawfully reduce one's surtaxes, by gift or otherwise, is permissible, and of itself raises no presumption of an intention to defraud the Government. We think the grantor has fully met the test of the regulation, unless the trustees, other than the grantor, have the power under the declaration to revest the grantor with the income or corpus, and have no power to invest any other person with such property who after such investiture must be considered as holding a substantially adverse interest to that of the grantor.

The Board held that the instrument gave to the grantor's wife and his brother, or the survivor of them, during the grantor's life; full power and authority to alter the instrument by changing the beneficiary, or by changing the time when the trust fund, or any part thereof, or the income, is to be distributed, or by changing the Trustees, or in any other respect. Hence it held that power to revest in the grantor was vested in the wife and brother, who were persons not having a substantial adverse interest in the corpus. If the wife and brother had the power under this provision to substitute the grantor as sole or part beneficiary, they likewise would have the same power to substitute themselves, or any one else, as beneficiaries. In either event it is not necessary that such event should have transpired. If the wife and brother had the power to name themselves, or others than the grantor, as beneficiaries, that power or right was certainly adverse to the grantor's interests. It was full and complete and not limited by reservation or failure of divestiture. Indeed, if the grantor by his instrument had in any manner reserved any interest in the property in question the other trustees would be powerless to pass a complete title. None of the cases cited by the Commissioner presented facts similar to those here. In each there was a clear reservation in the grantor, or a power or discretion in the trustees by means of which the grantor could be revested, and there was no power given any trustee, not a grantor, to substitute beneficiaries. See Kaplan v. Commissioner, 66 F. 2d 401; Rollins v. Helvering, 92 F. 2d 320; Altmaier v. Commissioner, 116 F. 2d 162; White v. Higgins, 116 F. 2d 312; Graff v. Commissioner, 117 F. 2d 247; Commissioner v. Caspersen, 119 F. 2d 94 (certiorari denied October 13, 1941); Kent v. Rothensies, 120 F. 2d 476 (certiorari denied October 13, 1941); Whiteley v. Commissioner, 120 F. 2d 782 (certiorari denied October 13, 1931).

However, we are not convinced that the wife and brother of the grantor were empowered by this instrument to revest title to this property in the grantor, their co-trustee. A court of equity has power to control the administration of a trust so that

it will accord with the purposes of the grantor. A discretion lodged in a trustee is rarely, if ever, to be regarded as a permit to act arbitrarily. Such discretion should be confined to the exercise of judgment not unreasonable in the light of the purposes of the trust and of the circumstances in which it is sought to be exercised. The power of the court exists solely for the protection of the right of the grantor and the beneficiaries (see Rollins v. Helvering, supra), and the laws of Illinois in this respect are applicable to this case. It was conceded in argument by the Commissioner that under the Illinois law the wife and brother as trustees would have no right to substitute themselves, or either of them, as beneficiaries, yet he insists that they would have the right to substitute their co-trustee, the grantor, as the sole beneficiary. If this be true then the grantor reserved nothing in the original grant, and there would be no tax due from him under the statute. See Huffman v. Commissioner, 39 B. T. A. 880.

However, we are convinced that the wife and brother as trustees had no authority under the Illinois law to revest the property in the grantor. This would be to give them power, not only to destroy the trust but to dissipate the proceeds contrary to the purposes set forth in the declaration, and it would also furnish an opportunity by secret agreement for subsequent distribution among the trustees. Such a door should not be left open. Congress and the courts, theoretically at least, have always regarded the preservation of trust funds as a sacred obligation, and they have always and everywhere proceeded on the theory that a trust officer should not be permitted to be placed in any position where he may be "tempted above that which he is able."

Both by law and the express request of the declaration, the meaning and effect of the trust is to be determined by the laws of Illinois. See Freuler v. Helvering, 291 U. S. 35; Blair v. Commissioner, 300 U. S. 5; Morgan v. Commissioner, 309 U. S. 78. Federal authorities control only those cases where the apparent transfer of a right to income is not real, or is only temporary. See Harrison v. Schaffner, 312 U. S. 579. Where great discretion is vested in a trustee, its exercise is subject to the control of a court of chancery. Maguire v. City of Macomb, 293 Ill. 441. A very broad discretion conferred upon a trustee in the selection of beneficiaries does not constitute an unlimited discretion which the court can not control. Welch v. Caldwell, 226 Ill. 488. In Jones v. Jones, 124 Ill. 254, the court said: "It is true that the daughters are invested with a large discretion as to the manner in which they shall execute the trust * * *; but the devise being to them for the use and benefit of the children of the deceased son, the discretion vested in them will not

defeat the trust. * * * The daughters, as trustees of this share, are not invested with discretion to withhold the trust fund absolutely from the cestuis que trust. The fund is not theirs, in equity, and they can not make it so by a refusal or neglect to exercise the discretion vested in them. Their discretion as trustees of this fund is subject to the control of the courts of equity, and can not be arbitrarily exercised so as to deprive the beneficiaries of all benefit of the fund." See also Frank v. Frank, 305 Ill. 181. The same principle seems to prevail in all jurisdictions both state and federal. See Restatement of Law of Trusts, Sec. 170; Scott on Trusts, Vol. 2, Sec. 187; Lovett v. Farnham, 169 Mass. 1, 47 N. E. 246; Fleischman v. Commissioner, 40 B. T. A. 672 (acquiesced in by Commissioner); Downs v. Commissioner, 36 B. T. A. 1129.

In the last-named case the Board said that "in the construction of a trust instrument the intention of the grantor is of utmost importance." This is true, and it constitutes the pole star which should guide courts in determining the purpose of the trust and the limitation of the trustee's discretion. We are convinced that under the terms of these trusts no contingency could arise which would enable the grantor to have the income or corpus distributed to him, actually or constructively, and it is well to note that the instrument itself provides for liability of the trustees in case of fraud or mismanagement.

The Commissioner urges that the Board's ruling must be sustained under Helvering v. Clifford, 309 U. S. 331. He seems to construe that decision as meaning that the interests of beneficiaries under a trust may be disregarded for purposes of taxing the grantor if the beneficiaries are members of his family, because they would probably not assert their rights. It can not well be denied in such event that a question presents itself for a court of chancery to determine, which federal courts will not ignore. We think the ruling in the Clifford case did not go so far as to hold that mere family solidarity gave the federal courts the right to ignore the State jurisdiction to determine the rights of beneficiaries under a trust, and the extent of the trustees' discretion. The elements required to bring a taxpayer within the scope of that case are quite clearly noticed in Helvering v. Elias, 122 F. 2d 171. They are (a) close family relationship, (b) short trust term, and (c) reservation of powers of management. See also Commissioner v. Barbour, 122 F. 2d 165. Certiorari was denied in both of these cases. In the present case we have no short terms, nor power of management in the grantor.

We think the Board erred in holding that the petitioner John Stuart was liable under Section 166 (2) of the Act, and from what we have said we are of the opinion that he was not liable

under Section 167 (a), which deals with revocable trusts, or under Section 22, which deals with gross income.

With respect to cause number 7696, the petitioner, R. Douglas Stuart, on March 25, 1942, created four separate trusts for the benefit of his four children, Robert, Anne, Margaret and Harriet. They were all minors and their birth dates respectively were [illegible] 25, 1916, January 11, 1920, January 3, 1922, and February [illegible].

The provisions of these trust agreements were substantially the same except for one provision hereafter noted. Each of the trusts comprised 1500 shares of common stock of the Quaker Oats Company, of which the petitioner was first vice-president. The trustees were the petitioner, his wife, Harriet McClure Stuart, and his brother, John Stuart.

The trust agreements provided that the trustees should pay to the child designated as the beneficiary of the particular trust agreement or apply to such child's education, support and maintenance, so much of the net income as the trustees should deem advisable, and that the trustees should add the unexpended portion of the net income to the principal of the particular trust. When the beneficiary became 30 years of age (25 years of age in the case of Robert) the trustees were to pay over to such beneficiary one-half of the principal of the trust. Thereafter the trustees were to pay over to the beneficiary the net income from the remaining one-half of the principal of the trust until such beneficiary became 35 years of age (30 years of age in the case of Robert) when the trustees were to pay over to the beneficiary the remaining one-half of the principal of the trust.

In the event of the death of a child of the petitioner before receiving all of the principal of his trust, the trustees were to pay over the principal of the trust to the child's issue then living, or, if there were no such issue, then to the living issue of the petitioner, or, if there were no such issue then living, then in equal shares to Princeton University and the Presbyterian Hospital of Chicago. The trustees were given the usual broad powers of management and administration. There was a spendthrift clause, a clause exonerating the trustees from liability except for fraud and willful mismanagement, a provision appointing a trust company as a co-trustee or sole trustee if two of the trustees should resign, and a provision that the trust should be governed by the laws of the State of Illinois.

Paragraphs eight and nine of these trusts are identical with paragraphs eight and nine of the John Stuart trust, except as to the names of the donor and the other two trustees.

On August 2, 1935, each of these trust agreements was amended by the two trustees, Harriet McClure Stuart and John Stuart,

by eliminating paragraph eight, and changing paragraph nine so as to make the indenture and all of its provisions irrevocable and not subject to alteration, change or amendment.

In all the years from the creation of the trusts to and including 1935, the entire net income of these trusts was accumulated and added to the principal, except that in 1934 there was distributed to Robert $1,391.50, and in 1935 there was distributed to him $1,882.50 of the income. At the time of the creation of the four trusts, the taxpayer's net worth was approximately $3,000,000, and the property which he transferred to the trusts had a value of approximately $600,000.

Bearing on the question of motive, the petitioner had discussed the matter with his brother, John Stuart, prior to the creation of the trusts by his brother, John, in 1930, and it seemed to this petitioner that John's was a wise procedure. When the trusts were created, petitioner's children were all minors. He said: "Times were very uncertain and I felt that while I had an opportunity to provide for them in the form of a trust, that was the wise thing to do." No changes have been made in the beneficiaries of the trusts nor in the property that went into them.

The Commissioner determined that the entire net income of the trusts for 1934, and from January 1 to August 2, 1935, was taxable to the petitioner under section 166 (2) of the Act, and the Board affirmed that determination. The Board did not deem it necessary to consider the applicability of sections 167 (a) and 22 (a) of the Act.

The same questions are presented in this case as were presented in the former case. The only factual difference with respect to the trusts of the two brothers is that during the years 1934 and 1935 John's children were all of age, and the children of Douglas were all minors. It is to be noted with respect to the trusts of the daughters of Douglas, that the entire income involved was accumulated and added to the principal for later distribution to them at the specified ages, whereas with respect to John's daughters substantially all the income was distributed currently to them. With respect to their sons, it is further to be noted that relatively small sums were paid to them, and the balance was accumulated and added to the principal.

What we have said in the case of the trusts for John's children, with respect to the applicability of sections 166 (2) and 167 (a) (2), need not be repeated. We hold that those two sections are not here applicable.

The remaining question is whether section 22 (a) is applicable, because of the minority of his children, under Douglas v. Willcuts, 296 U. S. 1. We think it is, to a limited extent, because in each trust here involved the indenture provides for the use of

the income for the education, support and maintenance of the minor children; and if it was so used, such applications, under the Willcuts case, must be considered as having been used for the grantor's benefit in the discharge of his obligation to his minor children. Such obligation is, of course, limited to a reasonable allowance consistent with the taxpayer's station in life, and the minor's welfare. Under the ruling of Commissioner v. Grosvenor, 85 F. 2d 2, the burden was on the grantor, if he were to escape taxation on the trust income, to prove that the distributed income was not in fact used for those purposes. We think that burden has been met with respect to all of the income of these trusts, with the exception of $1,391.50 which was paid to Robert in 1934, and $1,882.50 which was paid to him in 1935. All of the income received, aside from these two sums, was admitted to have been credited to principal, and this fact would seem to eliminate any possibility that it was or could ever be applied to the support or education of the minor children.

The Commissioner relies on Whiteley v. Commissioner, 120 F. 2d 782 (certiorari denied October 13, 1941), as holding that the income from the trusts must be taxed against the income of the taxpayer because it was available and could have been used to discharge his obligations to his minor children, although in fact it never was. We are not convinced that the Whiteley case goes that far, although the precise language referred to is found in that opinion if it be read separately from its context. In that case, and other seemingly analogous cases, there were clear reservations of rights to the grantor which might well be considered as bringing the trusts within the provisions of section 167 as well as section 22 (a). Indeed, the opinion in the Whitely case informs us, with respect to the childrens' trusts, that the respondent there relied upon sections 167 (a), (1) (2) (3) (b), and the court quotes them as the "applicable statute," and adds that "an examination of a line of Supreme Court decisions under section 22 (a), the gross income section of the statute, seems to leave little or no room to doubt the correctness of the Board's conclusion * * *" It should be further noted that that court also found that the settlor could have received the entire income and applied it to the support of his minor children, which he did not choose to do, and it further found that the settlor controlled the use of the money, neither of which rights did the settlor reserve in either of these trusts. The burden being on this taxpayer to prove that the distributed income was not in fact used for the education and support of his minor son, we think that the amount of such income which was actually received by him, or for him, must be considered as being income of the grantor, because there is no evidence to the contrary.

In cause number 7695 the decision of the Board is reversed. In cause number 7696 the Board's decision is affirmed as to the income which was distributed to Robert Stuart during the years 1934 and 1935. The decision is reversed as to those amounts of income which were not distributed to the beneficiaries but were credited to the corpora during the years in question. The causes are ordered remanded for further proceedings not inconsistent with this opinion.

A true Copy:
Teste:

Clerk of the United States Circuit Court of Appeals for the Seventh Circuit.

And, on the same day, to-wit: On the nineteenth day of December, 1941, the following further proceedings were had and entered of record, to-wit:

FRIDAY, *December 19, 1941.*

Court met pursuant to adjournment.

Before: Hon. William M. Sparks, Circuit Judge; Hon. J. Earl Major, Circuit Judge; Hon. Sherman Minton, Circuit Judge.

7695

JOHN STUART, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for Review of Decision of the United States Board of Tax Appeals

This cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the United States Board of Tax Appeals entered in this cause on January 10, 1941, be, and the same is hereby, reversed, and that this cause be, and it is hereby, remanded to the said United States Board of Tax Appeals for furthef proceedings not inconsistent with the opinion of this Court filed herein this day.

United States Circuit Court of Appeals For the Seventh Circuit

I, Kenneth J. Carrick, Clerk of the United States Circuit Court of Appeals for the Seventh Circuit, do hereby certify that

the foregoing typewritten and printed pages contain a true copy of the opinion filed on the nineteenth day of December, 1941, and the judgment entered on the nineteenth day of December, 1941, in the following entitled cause:

Cause No. 7695

JOHN STUART, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

as the same remains upon the files and records of the United States Circuit Court of Appeals for the Seventh Circuit.

In testimony whereof I hereunto subscribe my name and affix the seal of said United States Circuit Court of Appeals for the Seventh Circuit, at the City of Chicago, this thirteenth day of February A. D. 1942.

[SEAL]

KENNETH J. CARRICK,
Clerk of the United States Circuit Court of Appeals for the Seventh Circuit.

U. S. GOVERNMENT PRINTING OFFICE, 1942

SUPREME COURT OF THE UNITED STATES

Order allowing certiorari

Filed April 27, 1942

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Seventh Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

468654—42 U. S. GOVERNMENT PRINTING OFFICE: 1942

FILE COPY

Supreme Court, U. S.
FILED
MAR 19 1942
CHARLES ELMORE CROPLEY
CLERK

No. ~~1054~~ 48

In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN STUART

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN STUART

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Seventh Circuit entered in the above case on December 19, 1941, reversing the decision of the United States Board of Tax Appeals.

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 27–32) is unreported. The opinion of the Circuit Court of Appeals (R. 38–49) is not yet officially reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 19, 1941 (R. 49). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer executed three trusts, one for each of his three children, naming himself, his wife, and his brother as trustees. The trustees had complete dominion over the trust property, which consisted of shares of stock in a corporation of which the taxpayer was president and his brother was first vice president; in addition, the taxpayer retained substantial control over the corpus which he could exercise without the concurrence of the other two trustees. The beneficiary of each trust was to receive for fifteen years so much of the net income as the trustees in their sole discretion deemed advisable, the balance to be added to corpus. After the expiration of fifteen years the net income was to be paid to the child-beneficiary for life. During the life of the taxpayer, his wife and brother had power to "alter, change, or amend" the trusts "by changing the beneficiary * * * or in any other respect." Was the income from the trusts taxable to the grantor under Sections 166 (2), 167 (a), or 22 (a) of the Revenue Act of 1934?

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Apendix, *infra*, pp. 12–20.

STATEMENT

The facts, as stipulated (R. 12–20), and as found by the Board of Tax Appeals (R. 27–30), may be stated as follows:

The taxpayer in 1930 established three trusts in substantially identical terms, one for each of his three children.[1] He was president of the Quaker Oats Company and the corpus of each trust consisted of 700 shares of stock of that corporation (R. 27). At the time the trusts were created his net worth was in excess of $4,000,000, and the securities placed in trust had a value of approximately $575,000 (R. 30).

The taxpayer named himself, his wife, and his brother[2] as the trustees of each trust (R. 27). The trustees were given broad powers of management (R. 28), and each trust contained an exculpatory clause relieving the trustees of liability except for "actual fraud or willful mismanagement" (R. 28–

[1] During the years involved, 1934 and 1935, the children were adult (R. 27).

[2] The brother, Robert Douglas Stuart, was also the grantor of four similar trusts, one for each of his four children, and his liability for tax with respect to the income therefrom is involved in a companion case which was disposed of by the court below together with this case in a single opinion. Robert Douglas Stuart was vice president of the Quaker Oats Company.

29). In addition, the taxpayer reserved the right to himself to direct the sale of the corpus and reinvestment of the proceeds, as well as the right to withdraw and take over the corpus upon substituting other property of an equal market value. (See Paragraph "Eighth", R. 29.)

Each trust provided that for a period of fifteen years the trustees were to pay over to the child designated as beneficiary, "so much of the net income from the Trust Fund as they in their sole discretion shall deem advisable," and to add the undistributed income to corpus (R. 27–28). After the fifteen-year period, the trustees were to pay the entire net income to the beneficiary for life, and upon death of the beneficiary, to pay over the principal to the beneficiary's surviving issue, with remainders over in the event of default.

Two of the trustees, the taxpayer's wife and his brother, were given sweeping powers to alter, change, or amend the trust, including the power to change the beneficiary. In that respect, paragraph "Ninth" of each trust provided as follows (R. 29):

> Ninth. During the life of the Donor, the said Ellen Shumway Stuart and the said Robert Douglas Stuart, or the survivor of them, shall have full power and authority, by an instrument in writing signed and delivered by them or by the survivor of them to the Trustees, to alter, change or amend this Indenture at any time and from time to time by changing the beneficiary hereunder,

> or by changing the time when the Trust Fund, or any part thereof, or the income, is to be distributed, or by changing the Trustees, or in any other respect.

On August 3, 1935, the taxpayer's wife and brother executed an amendment to each of the three trusts cancelling paragraph "Eighth" (dealing with the taxpayer's right to withdraw corpus, etc.) and changing paragraph "Ninth" to read as follows (R. 29):

> Ninth. This Indenture and all of the provisions thereof are irrevocable and not subject to alteration, change or amendment.

The taxpayer's brother had similarly created like trusts (see footnote 2, *supra*) for his own children, naming himself, his wife and the taxpayer as trustees, with like powers of alteration vested in the latter two trustees. And at about the same time in August 1935, the taxpayer and his brother's wife, made similar changes in his brother's trusts eliminating the power of further alteration therein.

The question in this case is whether trust income for the year 1934 and that portion of 1935 prior to the foregoing modification may be charged to the donor for income-tax purposes. The Board of Tax Appeals sustained the tax. The court below reversed, rejecting the Government's contentions that the income was taxable to the donor, (1) under Section 166 (2) or Section 167 (a) of the

Revenue Act of 1934 in view of the power of the other two trustees to revoke the trust or to deflect the income to him; (2) under Section 22 (a) in view of the taxpayer's continued control over the corpus amounting to substantial ownership.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that the income from the trusts was not taxable to the taxpayer under Section 166 of the Revenue Act of 1934.

(2) In holding that the income from the trusts was not taxable to the taxpayer under Section 167 of the Revenue Act of 1934.

(3) In holding that the income from the trusts was not taxable to the taxpayer under Section 22 (a) of the Revenue Act of 1934.

REASONS FOR GRANTING THE WRIT

1. Under paragraph "Ninth" of each trust indenture respondent's brother and wife had full authority to "alter, change, or amend" the trust "by changing the beneficiary hereunder * * * or in any other respect." The income therefrom was therefore taxable to the donor under the unambiguous provisions of Sections 166 (2) and 167 (a), and the decision of the court below defeats the very objective at which those provisions were aimed. Prior to the Revenue Act of 1932 the literal terms of Section 166 provided for the taxation of the income of a trust to a grantor only

where he had retained some power either alone or in conjunction with some other person (not adversely interested) to revest the corpus in himself. The language of the statute was changed in the 1932 Act expressly in order to include the situation where the grantor did not share in the power [3] and as so changed was carried over into the Revenue Act of 1934, the statute involved herein.

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[3] S. Rep. No. 665, 72d Cong., 1st Sess., p. 34 (1939–1 Cum. Bull. (Part 2) 496); with respect to the bill that became the Revenue Act of 1932 contains the following language:

"Under the present law the income of a trust is taxable to the grantor where, at any time during the taxable year, the grantor has power to revest in himself title to any part of the corpus of the trust, either alone or in conjunction with any person not a beneficiary of the trust. In an attempt to avoid this section, the practice has been adopted by some grantors of reserving power to revest title to the trust corpus in conjunction with a beneficiary having a very minor interest or of conferring the power to revest upon a person other than a beneficiary; in such cases the grantor has substantially the same control as if he alone had power to revoke the trust. While it is, of course, yet to be established that such device accomplishes its purpose, it is considered expedient to make it clear that in any of these cases the income shall be taxed to the grantor. The House bill made the grantor of a trust taxable upon the income of any part of the corpus of the trust, where the power to revest in the grantor title to such part of the corpus was in the grantor alone or was in the grantor in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus. *Your committee has extended the scope of this provision so as to include, as well, the cases where the power to revest title to any part of the corpus is held, either alone* or in conjunction with the grantor, by a person not having a substantial adverse interest in such part of the corpus or in the income therefrom." [Italics supplied.]

In failing to give effect to the provisions of Section 166 (2), the decision below is in conflict with *Fulham* v. *Commissioner*, 110 F. (2d) 916 (C. C. A. 1st); and in failing to give effect to the provisions of Section 167 (a), the decision is in conflict with *Altmaier* v. *Commissioner*, 116 F. (2d) 162 (C. C. A. 6th), certiorari denied, 312 U. S. 706; *Rollins* v. *Helvering*, 92 F. (2d) 390 (C. C. A. 8th), certiorari denied, 302 U. S. 763; *White* v. *Higgins*, 116 F. (2d) 312 (C. C. A. 1st); and *Kent* v. *Rothensies*, 120 F. (2d) 476 (C. C. A. 3d), certiorari denied, October 13, 1941, No. 537, present Term.[4]

The suggestion of the court below that Sections 166 and 167 are inapplicable because the trustees had a substantial adverse interest is without foundation. The trustees did not have any "substantial adverse interest" in the trusts; they were not beneficiaries and to the extent that they could exercise the power to substitute themselves as bene-

[4] The intimation of the court below that the provisions of Section 166 (2) and Section 167 (a) are inapplicable here since the brother and wife, under Illinois law, had to exercise their discretion as to change of beneficiary, etc., with due regard to their fiduciary duties is in the teeth of *Reinecke* v. *Smith*, 289 U. S. 172, 176–177. There, the identical argument was made with respect to a trust also controlled by Illinois law, and the taxpayer has not relied upon any Illinois cases here that were decided after *Reinecke* v. *Smith*. And in holding that the existence of fiduciary duties under state law forbids the imposition of the tax, the decision below is contrary to *Fulham* v. *Commissioner*, *supra*; *White* v. *Higgins*, *supra*; *Cox* v. *Commissioner*, 110 F. (2d) 934 (C. C. A. 10th), certiorari denied, 311 U. S. 667.

ficiaries, the taxpayer could similarly participate in the exercise of like powers with respect to the like trusts established by his brother. In these circumstances, and in the light of the business and family relationships, the Board's determination that the trustees did not have a substantial adverse interest finds ample support in the record. Moreover, the very purpose of these provisions in Sections 166 (2) and 167 (a) was to reach cases where the grantor would place the power of amendment or revocation in the hands of persons who would normally be responsive to his desires, and persons most likely to fall in that category are members of his immediate family. To the extent that the decision below reaches a different result it is in conflict with *Altmaier* v. *Commissioner*, 116 F. (2d) 162 (C. C. A. 6th), certiorari denied, 312 U. S. 706; *Fulham* v. *Commissioner*, 110 F. (2d) 916 (C. C. A. 1st); *Loeb* v. *Commissioner*, 113 F. (2d) 664 (C. C. A. 2d); and *Commissioner* v. *Casperson*, 119 F. (2d) 94 (C. C. A. 3d), certiorari denied, October 13, 1941, No. 220, present Term.

2. The decision below is also in substantial conflict with *Commissioner* v. *Buck*, 120 F. (2d) 775 (C. C. A. 2d), and *Commissioner* v. *Brown*, 122 F. (2d) 800 (C. C. A. 3d), with respect to the application of the principles established by *Helvering* v. *Clifford*, 309 U. S. 331. The conflict on this point is present even upon the assumption that no

change could have been made in the trusts herein which would have diverted any part of the corpus or income to the grantor.

In the *Buck* case the trust was unlimited as to term; the named beneficiaries were the grantor's wife and children, and his reserved power to change the beneficiaries was limited so that he could not divert any part of the income or corpus to himself; he retained the powers to remove the trustee, to direct the trustee in the retention, disposition, and investment of the corpus, and to vote any stock or to direct the trustee how to vote it. The Second Circuit held the doctrine of the *Clifford* case applicable and the income taxable to the grantor under Section 22 (a).

The *Brown* case was essentially similar to the *Buck* case. It presented a somewhat stronger case for the taxpayer in that the powers of management could be exercised only indirectly by the substitution of trustees, and the named beneficiaries were not related to the grantor. The Third Circuit followed the decision in the *Buck* case and held Section 22 (a) applicable.

The instant case presents a comparable picture. The named beneficiaries were subject to change by persons whom the Board has found would be amenable to the taxpayer's wishes. Certainly in view of the broad powers of management vested in the taxpayer alone as grantor by Article Eighth of the indentures (R. 17–18) and in him as one

of the trustees by Articles Second and Tenth (R. 15, 18), the court below erred in stating that there was no power of management in the grantor. It is also significant that the corpus of each trust consisted of shares of stock in the Quaker Oats Company, of which the taxpayer was president. By Article Eighth of the indentures he reserved sufficient power to reacquire that stock and vote it as he chose, in the remote event of any disagreement between himself and the other trustees. There is a substantial conflict therefore between the instant case and the *Buck* and *Brown* cases.

CONCLUSION

The decision below conflicts with decisions in other circuits in several vital respects upon questions of public importance in the administration of the Revenue Acts. It is therefore respectfully submitted that the petition be granted.

CHARLES FAHY,
Solicitor General.

MARCH 1942.

APPENDIX

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal services, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * *

(U. S. C., Title 26, Sec. 22.)

SEC. 166. REVOCABLE TRUSTS.

Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—

(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or

(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom,

then the income of such part of the trust shall be included in computing the net income of the grantor. (U. S. C., Title 26, Sec. 166.)

SEC. 167. INCOME FOR BENEFIT OF GRANTOR.

(a) Where any part of the income of a trust—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23 (o), relating to the so-called "charitable contribution" deduction);

then such part of the income of the trust shall be included in computing the net income of the grantor.

(b) As used in this section, the term "in the discretion of the grantor" means "in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question." (U. S. C., Title 26, Sec. 167.)

Treasury Regulations 86, as originally promulgated under the Revenue Act of 1934:[5]

ART. 166–1. *Trusts in the corpus of which the grantor retains an interest.*—(a) *Scope.*—Section 166 prescribes that the income, or any part of the income, of certain trusts shall be taxed, not to the trustee nor to the beneficiaries, but to the grantor because of the fact that the grantor has retained a certain interest in the property of the trust. This article deals with the taxation of such income. The term "corpus," as used in this article, means any part or the whole of the property, real or personal, constituting the subject matter of the trust.

(b) *Test of taxability to the grantor.*—The sufficiency of the grantor's retained interest in the corpus resulting in the taxation of its income to the grantor is determined by a single test, namely, whether the grantor has failed to divest himself, permanently and definitively, of every right which might by any possibility enable him once more to possess and enjoy in title the trust corpus. For the purposes of this article the sufficiency of the grantor's retained interest in the corpus is not affected by the fact that the grantor has provided that the right to cause the title to the corpus to revest in himself is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a

[5] ART. 166–1 was amended on March 7, 1936, by T. D. 4629, XV–1 Cum. Bull. 140 (1936). Art. 167–1 was amended by T. D. 4759 on September 7, 1937, 1937–2 Cum. Bull. 117, and by T. D. 4860 on September 12, 1938, 1938–2 Cum. Bull. 184. No question in the case turns upon any change in the Regulations made by these amendments.

substantial interest in the corpus or income therefrom adverse to the grantor.

If the grantor has retained any such interest in the corpus he is taxable on the income therefrom regardless of—

(1) how great or how small, how remote or how contingent the interest may be;

(2) whatever the nature of interest retained may be; whether the interest retained is vested, contingent, in reversion, or otherwise; whether conditioned on the precedent giving of notice, or on elapsing of a period of years, or on the happening of a specified event; whether taken by appointment, or by designation in the trust instrument, or merely by virtue of the grantor not conveying his whole estate in the corpus, or otherwise;

(3) the time or times at which such interest will revest the title in the grantor in possession and enjoyment, whether within or without the taxable year, whether or not the time be fixed, determinable or certain to come;

(4) whether, if the revesting in the grantor of title to the corpus is in any way dependent upon the act of anyone, that person be the grantor, or any person not having a substantial interest in the corpus or income therefrom adverse to the grantor, or both. A bare legal interest, such as that of a trustee, is never substantial and never adverse;

(5) when the trust was created.

For example, a grantor has not permanently or definitively divested himself of title to the corpus if he has placed it in trust for his son, John,

(A) for the term of three years, at the end of which time the trust might be ex-

tended for a like period at the option of the grantor and successively thereafter, but in the absence of such an extension the title is once more to revest in the grantor in possession and enjoyment; or

(B) for the term of a year and a day, then to be distributed to whomsoever the wife of the grantor shall by deed appoint (the wife not being a beneficiary, but being empowered to appoint to anyone other than herself); or

(C) for the term of the grantor's life, then to be distributed to John, the grantor reserving, however, the right to alter, amend, or revoke any provision of the trust instrument, upon notice of a year and a day.

In these typical cases the grantor has provided that the title shall or may once more revest in himself by the retention of an interest (executory or otherwise) capable of vesting title in the grantor in possession and enjoyment, in (A) upon the expiration of the trust period if the grantor does not exercise his option to extend the trust, in (B) upon the designation of the grantor as distributee, by a person not substantially and adversely interested, and in (C) upon the revocation of the trust instrument or an alteration or amendment thereof, resulting in the designation of the grantor as distributee.

Thus the inclusion within the scope of section 166 of any trust is based on the fact that the grantor has retained an interest in the corpus which once more will, or may possibly, vest the title in him in possession and enjoyment. Section 166 makes no distinction between a "revocable trust" (so-

called because of a provision in the trust instrument permitting some person at some time or in some manner to terminate the trust) and an "irrevocable trust" as such. Some "revocable trusts" are within the scope of section 166, not however by reason of the element of revocability, but because the grantor has reserved the requisite interest in the trust corpus, whether the vesting in title of such interest depends on revocation or otherwise. If no such interest has been retained, a "revocable trust" is not within the scope of section 166, even though the particular trust estate is subject to revocation by the grantor.

If the grantor strips himself permanently and definitively of every such interest in the corpus retained by him, the income of the trust realized after the effective date of such divesting is not taxable to the grantor but is taxable as provided in sections 161 and 162.

(c) *Income and deductions.*—If, as to any of the corpus, the test of taxability to the grantor is satisfied, the gross income of such corpus shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to such corpus as he would have been entitled to had the trust not been created.

ART. 167–1. *Trusts in the income of which the grantor retains an interest.*—(a) *Scope.*—Section 167 prescribes that the income, or any part of the income, of certain trusts shall be taxed to the grantor, not because the grantor has retained a certain interest in the *corpus* of the trust (as in section 166), but because of his retention of a certain interest in the *income* of the trust. This article deals with the taxation of such

income. The term "income," as used in this article, means any part or the whole of the income of the trust.

(b) *Test of taxability to the grantor.*— The test of the sufficiency of the grantor's retained interest in the trust income, resulting in the taxation of such income to the grantor, is whether the grantor has failed to divest himself, permanently and definitively, of every right which might, by any possibility, enable him to have the income, at some time, distributed to him, actually or constructively. Such a distribution to the grantor occurs if the income is paid to him or to another according to the grantor's direction or if, though paid to another pursuant to the terms of the trust, the benefit of the income inures to the grantor. The income so inures if it is or may be applied in satisfaction of a legal obligation of the grantor, does or may increase his net worth, does or may in any way enrich him, or does or may enable him in any way to enjoy, in substance, such income. Such a distribution also occurs if the income is applied in payment of premiums upon policies of insurance on the grantor's life.

For the purposes of this article, the sufficiency of the grantor's retained interest in the income is not affected by the fact that the grantor has provided that the right to so effect or direct the distribution of income is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a substantial interest in the income adverse to the grantor.

If the grantor has retained any such interest in the income, such income is taxable to the grantor regardless of—

(1) whether it may be distributed currently or accumulated for future distribution;

(2) whether such distribution, either current or subject to accumulation, is fixed by the trust instrument or is dependent on an exercise of discretion;

(3) whether, if such distribution is in any way effected by or dependent on an exercise of discretion, the person exercising the discretion is the grantor or a person not having a substantial interest in the income adverse to the grantor, or both. A bare legal interest, such as that of a trustee, is never substantial and never adverse;

(4) whether, if such distribution results in the inuring of benefits to the grantor from the application of the income in satisfaction of his legal obligation, such obligation is to pay a debt, to support dependents, to pay alimony, to furnish maintenance, and support or otherwise;

(5) the time or times of such distribution, whether within or without the taxable period, whether conditioned on the precedent giving of notice, or on the elapsing of an interval of time, or on the happening of a specified event, or otherwise;

(6) when the trust was created.

Thus the inclusion of any trust within the scope of section 167 is based on the fact that the grantor has retained an interest in the income therefrom by which he is, or may be enabled at some time, to receive its benefits. If the grantor strips himself permanently and definitively of every such interest retained by him, the income of the trust realized after such divesting takes effect is not taxable to the grantor, but is

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taxable as provided in sections 161 and 162.

(c) *Income and deductions.*—If, as to any of the income, the test of taxability to the grantor is satisfied, such income shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to such income as he would have been entitled had such income been distributable currently to him.

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No. 48

In the Supreme Court of the United States

OCTOBER TERM, 1942

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN STUART

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 48

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN STUART

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 27–32) is unreported. The opinion of the Circuit Court of Appeals (R. 38–49) is reported in 124 F. (2d) 772.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered December 19, 1941 (R. 49). The petition for a writ of certiorari was filed March 19, 1942, and was granted April 27, 1942. The jurisdiction of this Court is conferred by section

240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer established three trusts, one for each of his three children, naming himself, his wife and his brother as trustees. The corpus of each trust consisted of shares of stock in a corporation of which the taxpayer was president and his brother was first vice president. The grantor reserved the right to direct the trustees with respect to sales and reinvestments of trust property. During the grantor's life, his wife and brother had power to change the beneficiaries and to amend the indentures in any respect. Is the grantor accountable under Sections 166, 167, or 22 (a) of the Revenue Act of 1934 for the income of these trusts?

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations are set forth in the Appendix, *infra*, pp. 34–49.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 27–30) may be summarized as follows:

Taxpayer and his wife, Ellen Shumway Stuart, have three children: Joan, born May 31, 1904; Ellen, born June 21, 1907; and John, born January 1, 1912 (R. 27).

On March 31, 1930, taxpayer created three separate trusts, one for the benefit of each of his three children, and named himself, his wife, and his

brother, Robert Douglas Stuart, as the trustees of each trust. To the trustees of each trust taxpayer transferred 700 shares of the common stock of the Quaker Oats Company, of which he was president (R. 27).

The provisions of each of the three trust indentures were substantially the same. For a period of fifteen years the trustees were to pay over to the child designated as the beneficiary of the particular trust so much of the net income from the trust fund as they in their sole discretion should deem advisable and add the balance to corpus. After fifteen years the trustees were to pay the entire net income from the trust to the beneficiary for life (R. 27–28).

Upon the death of the beneficiary, the trustees were to pay over the principal of the trust to the beneficiary's issue then surviving or, if the beneficiary left no issue then surviving, to the issue then surviving of the taxpayer; or, if there were surviving no issue of the beneficiary or of taxpayer, to Princeton University and the University of Chicago in equal shares (R. 28).

The trustees were empowered to collect all income; to sell any of the securities held in trust; to invest the proceeds from the sale of securities and the net income added to trust principal in income-producing property or securities, real or personal, without being restricted to investments fixed by the statutes of Illinois; to execute all

necessary assignments and other instruments; to exercise the voting power upon all shares of stock held in trust; to exercise every power, and do every act and thing in respect of any shares of stocks and bonds which they could or might do if they were absolute owners thereof; to unite with others in carrying out any plan for the reorganization of any corporation, the securities of which were held in trust; to exchange the securities of any corporation for other corporate securities; to assent to the consolidation or merger of any corporation; to pay assessments and expenses for the protection of the interest of the trust in the securities of any corporation; and to employ agents and attorneys (R. 28).

Stock dividends, liquidating dividends and proceeds from the sale of any part of the trust funds, including profits, were to constitute principal (R. 28).

Each trust indenture contained a clause providing that the trustees were not to incur any liability except such as might be due to actual fraud or willful mismanagement, and a clause providing that any person dealing with the trustees was not to be required to see to the application of any money paid to the trustees (R. 28–29).

Paragraphs Eighth and Ninth of each trust indenture provided as follows (R. 29):

> Eighth. The Donor reserves and shall have the right at any time and from time

to time to direct the Trustees to sell the whole of the Trust Fund, or any part thereof, and to reinvest the proceeds in such other property as the Donor shall direct. The Donor further reserves and shall have the right at any time and from time to time to withdraw and take over to himself the whole or any part of the Trust Fund upon first transferring and delivering to the Trustees other property satisfactory to them of a market value at least equal to that of the property so withdrawn.

Ninth. During the life of the Donor, the said Ellen Shumway Stuart and the said Robert Douglas Stuart, or the survivor of them, shall have full power and authority, by an instrument in writing signed and delivered by them or by the survivor of them to the Trustees, *to alter, change or amend this Indenture at any time and from time to time by changing the beneficiary hereunder,* or by changing the time when the Trust Fund, or any part thereof, or the income, is to be distributed, or by changing the Trustees, *or in any other respect.* [Italics supplied.]

On August 3, 1935, taxpayer's wife and brother executed an amendment to each of the three trust indentures, canceling paragraph Eighth and changing paragraph Ninth to read as follows (R. 29):

Ninth. This Indenture and all of the provisions thereof are irrevocable and not subject to alteration, change or amendment.

The net income of each of the three trusts in 1934 and 1935 was as follows (R. 29):

Trust for—	1934	1935
Joan	$7,496.74	$8,295.00
Ellen	7,496.74	8,295.00
John	7,566.54	9,135.00
Total	22,560.02	25,725.00

Of the $25,725 income of the three trusts for 1935, $16,800 was received during the period from January 1, 1935, to August 3, 1935 (R. 30).

In 1934 and 1935 the following amounts of the net income of the three trusts were distributed to the beneficiaries (R. 30):

Trust for—	1934	1935
Joan	$7,496.74	$7,675.36
Ellen	7,496.74	7,473.80
John	1,393.35	2,740.50

In 1934 and 1935 Joan and Ellen were married (R. 30).

Taxpayer's net income (not including any income of the three trusts) was $167,257.45 in 1934 and $185,334.77 in 1935. At the time of the creation of the three trusts, taxpayer's net worth was in excess of $4,000,000, and the property which he transferred to the trusts had a value of approximately $575,000 (R. 30).

In determining the deficiencies for 1934 and 1935, the Commissioner included in the taxpayer's income the net income of each of the trusts for

1934 and the period from January 1 to August 3, 1935. The Board of Tax Appeals sustained the Commissioner's action but the court below reversed the decision of the Board.

This is a companion case to *Helvering* v. *R. Douglas Stuart*, No. 49, present Term, which has been placed on the summary docket for argument immediately following the instant one. In that case, as more fully shown by the record therein, to which reference is here made, the taxpayer created four trusts, one for the support and benefit of each of his four minor children, naming himself, his wife and his brother (the grantor in the instant case) as trustees. The corpus of each trust consisted of shares of stock in the Quaker Oats Company of which both brothers were officers. The trusts contained substantially the same provisions as the instant ones and also empowered the grantor's wife and brother to make any changes in those provisions. On August 2, 1935, the wife and brother relinquished that power. The *R. Douglas Stuart* case involves the same questions as the instant one and also an additional question, based upon the minority of his children, which is not presented here.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that the trust income was not taxable to the grantor under Sections 166, 167 or 22 (a) of the Revenue Act of 1934.

(2) In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

I

Section 166 of the Revenue Act of 1934 (Appendix, *infra*) provides that where at any time the power to revest in the grantor title to the corpus of a trust is vested in the grantor or in any person not having a substantial adverse interest, then the income of the trust is taxable to the grantor. In the instant case the grantor established three trusts, one for each of his children. During the grantor's lifetime, his wife and brother had power to change the beneficiaries and to amend the indentures in any respect. In the circumstances the statute is applicable, for the wife and brother could have revested in the grantor title to the trust properties and their interests were in harmony with and not adverse to those of the grantor in any real sense. The Board of Tax Appeals so held and its decision, which was reversed by the court below, should now be reinstated. Our position is supported by the Treasury Regulations, the legislative history and the applicable decisions of the courts.

II

Section 167 of the Revenue Act of 1934 (Appendix, *infra*) provides that where the income of

a trust is, or in the discretion of the grantor or of any person not having a substantial adverse interest may be, held or accumulated for future distribution to the grantor or, may, in the discretion of the grantor or of any person not having a substantial adverse interest, be distributed to the grantor; then the trust income shall be taxed to the grantor. In the instant case, under the broad power conferred upon the grantor's wife and brother, they could have changed the indentures so as to provide that the trust income be held or accumulated for future distribution to the grantor or that it be distributed to him currently. Hence the statute applies, for the wife and brother did not have interests which were substantially adverse to those of the grantor. Our views are supported by the regulations, the legislative history, and the pertinent court decisions.

III

As a further alternative, we submit that the grantor is taxable under section 22 (a) of the Revenue Act of 1934 (Appendix, *infra*) because he retained so many of the attributes of ownership in the trust properties as to justify treating him as owner under the theory of *Helvering* v. *Clifford*, 309 U. S. 331.

ARGUMENT

I

THE TRUST INCOME IS TAXABLE TO THE GRANTOR UNDER SECTION 166 OF THE REVENUE ACT OF 1934

Introductory.—The operation of section 166 (2) of the Revenue Act of 1934 (Appendix, *infra*) is not dependent on the grantor's having power himself to retake the corpus of the trust. This section taxes the grantor on the income of a trust wherever any person without a substantial adverse interest has power to revest title to the corpus of the trust in the grantor. In the instant case the grantor's wife and brother possessed the power to change the beneficiaries and to change completely the provisions of the trusts, including the power to restore the corpus to the grantor. Neither the wife nor the brother were beneficiaries in the trusts, and if neither of them had a substantial adverse interest, as we shall undertake to demonstrate, the grantor was taxable on the trust income under section 166 (2).

The legislative history of section 166 shows that the instant situation is the very type which was intended to be included within the statute. The first specific provision taxing grantors of revocable trusts upon the income therefrom[1]

[1] This provision was section 219 (g) of the Revenue Act of 1924, c. 234, 43 Stat. 253, which provided as follows: "SEC. 219. * * * (g) Where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction

might not have reached this type of case, because it may have been applicable only where the power of revocation was in the grantor, either alone or in conjunction with someone not a beneficiary. In 1932 this provision was amended by section 166 of the Revenue Act of that year.[2] The purpose behind the changes in the provision is disclosed by the report of the Senate Committee on Finance (S. Rep. No. 665, 72d Cong., 1st Sess., p.

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with any person not a beneficiary of the trust, the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." Subsequently the courts held that this provision was merely declaratory of existing law and that such grantors were also taxable under the general provisions of prior laws. *McCauley* v. *Commissioner*, 44 F. (2d) 919 (C. C. A. 5); *Dickey* v. *Burnet*, 56 F. (2d) 917 (C. C. A. 8), certiorari denied, 287 U. S. 606; *O'Donnell* v. *Commissioner*, 64 F. (2d) 634 (C. C. A. 9), certiorari denied, 290 U. S. 699. This provision was reenacted in the 1926 and 1928 Acts (Revenue Act of 1926, c. 27, 44 Stat. 9, sec. 219 (g); Revenue Act of 1928, c. 852, 45 Stat. 791, sec. 166) and was held constitutional in *Corliss* v. *Bowers*, 281 U. S. 376.

[2] Section 166 of the 1932 Act, c. 209, 47 Stat. 169, read as follows: "SEC. 166. *Revocable Trusts.* Where at any time during the taxable year the power to revest in the grantor title to any part of the corpus of the trust is vested — (1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or (2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." Except for a change not here material the 1934 provision here involved is identical.

34 (1939–1 Cum. Bull. (Part 2), pp. 496, 520–521)), as follows:

SECTION 166. REVOCABLE TRUSTS.

Under the present law the income of a trust is taxable to the grantor where, at any time during the taxable year, the grantor has power to revest in himself title to any part of the corpus of the trust, either alone or in conjunction with any person not a beneficiary of the trust. *In an attempt to avoid this section, the practice has been adopted by some grantors of reserving power to revest title to the trust corpus in conjunction with a beneficiary having a very minor interest or of conferring the power to revest upon a person other than a beneficiary; in such cases the grantor has substantially the same control as if he alone had power to revoke the trust.* While it is, of course, yet to be established that such device accomplishes its purpose, it is considered expedient to make it clear that in any of these cases the income shall be taxed to the grantor. The House bill made the grantor of a trust taxable upon the income of any part of the corpus of the trust, where the power to revest in the grantor title to such part of the corpus was in the grantor alone or was in the grantor in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus. *Your committee has extended the scope of this provision so as to include, as well, the*

cases where the power to revest title to any part of the corpus is held, either alone or in conjunction with the grantor, by a person not having a substantial adverse interest in such part of the corpus or in the income therefrom. [Italics supplied.]

This report is of double significance. It not only states that the section was being amended to tax the grantor where the power to revest lay not in him but in another person without a substantial adverse interest, but it also tends to afford certainty to the meaning of the term "a substantial adverse interest." The report shows concern with a practice of a two-fold nature which had arisen: grantors were conferring the power of revocation either (1) on "a person other than a beneficiary" or (2) conjunctively with the grantor on "a beneficiary having a very minor interest," and thus were seeking to avoid the effect of a statute which did not tax them unless they reserved power in themselves to revoke "either alone or in conjunction with any person not a beneficiary." In consequence of this concern, the phrase "any person not having a substantial adverse interest" was placed in the statute, making the grantor taxable wherever such a person, either alone or with the grantor, could revest title to the corpus in the grantor. By use of the phrase "any person not having a substantial adverse interest" the committee thus intended to describe

(1) beneficiaries with minor interests and (2) all persons other than beneficiaries.

The court below, however, refused to give effect to the plain language of section 166 and the unambiguous purpose of Congress. As we read the court's opinion, it ruled: (1) That section 166 applies only where the grantor has reserved in his grant the right to recapture the corpus by his own act and the grantor here reserved no such right; (2) that in any event the fiduciary position of the grantor's wife and brother prevented them from restoring the corpus to the grantor; and (3) that, finally, the wife and brother had substantial adverse interests. We submit that the court erred in each respect.

1. Section 166 plainly provides that the grantor shall be taxed if the requisite power is either reserved by the grantor or is bestowed on any person not having a substantial adverse interest. The court below seemed to rest its conclusion that the grantor is taxable only where he himself has the power of revocation, on certain language in Article 166–1 (b) of Treasury Regulations 86, as originally promulgated (Appendix, *infra*). This regulation provided in part that the single test of taxability is whether the grantor has failed to divest himself, permanently and definitely, of every right which might by any possibility enable him once more to possess and enjoy in title the trust corpus. But the true significance of this

portion of the regulation is apparent when it is read in conjunction with the sentence immediately following it:

> For the purposes of this article the sufficiency of the grantor's retained interest in the corpus is not affected by the fact that the grantor has provided that the right to cause the title to the corpus to revest in himself is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a substantial interest in the corpus or income therefrom adverse to the grantor.

This and other provisions of the regulations, both as originally adopted and as amended (Appendix, *infra*), abundantly evidence the lack of any adequate basis for the conclusion that those regulations have interpreted the statute to apply only where the power to revest is excercisable by the grantor himself. And we know of no other case where the statute and the regulations have been so construed. On the other hand, the courts have uniformly held that the grantor is taxable where the power to revest is exercisable only by another person not having a substantial adverse interest. *Morton* v. *Commissioner,* 109 F. (2d) 47 (C. C. A. 7); *Helvering* v. *Evans,* 126 F. (2d) 270 (C. C. A. 3), application for certiorari pending, Nos. 107–108, present Term; cf. *Commissioner* v. *Caspersen,* 119 F. (2d) 94 (C. C. A. 3), certiorari denied, 314 U. S. 643; *Loeb* v. *Commissioner,*

113 F. (2d) 664 (C. C. A. 2), certiorari denied, 311 U. S. 710. Indeed, the court below was apparently not content to dispose of section 166 solely upon its conclusion as to this point for it proceeded to consider the other questions raised by the parties.

2. The next question is whether the grantor's wife and brother had power to restore the trust properties to him. We submit that the provisions of Article Ninth of the agreement, above referred to, are broad enough to authorize such action. The Board of Tax Appeals so construed the agreement but the court below took the view that under the law of Illinois the power was a fiduciary power, vested in the wife and brother as trustees, and subject to the control of a court of chancery which would not permit them to defeat the interests of the children-beneficiaries. We submit that such reasoning is fallacious because it virtually nullifies the existence of the power, since it is difficult to imagine how the express power to change beneficiaries could be exercised at all if it could not be exercised so as to defeat the interests of the original beneficiaries. Such reasoning is fallacious for the added reason that it overlooks the essential character of the power, which was a general power given to the wife and brother as individuals, not as trustees. The exercise of the power was not subject to fiduciary obligations. It is immaterial that the wife and brother were also named as trustees.

Reinecke v. *Smith*, 289 U. S. 172, 176–177, is dispositive of this issue. See also *Chandler* v. *Commissioner*, 119 F. (2d) 623 (C. C. A. 3).

Even if the question be examined *de novo*, however, it seems clear that under the law of Illinois, the wife and brother could have transferred the corpus back to the grantor without interference by a court of equity. *The People* v. *Kaiser*, 306 Ill. 313, 316–317; *Rock Island Bank* v. *Rhoads*, 353 Ill. 131, 141; *Botzum* v. *Havana National Bank*, 367 Ill. 539, 543; *Pomeroy's Equity Jurisprudence* (5th ed.), Vol. 3, sec. 1002. There is no suggestion in the instant case that the donees of the power were indebted so that they might have been required to exercise it in favor of their creditors in preference to any other person. *Gilman* v. *Bell*, 99 Ill. 144, 151; *Northern Trust Co.* v. *Porter*, 368 Ill. 256, 266–267. Cases such as *Maguire* v. *City of Macomb*, 293 Ill. 441; *Welch* v. *Caldwell*, 226 Ill. 488; *Jones* v. *Jones*, 124 Ill. 254; and *Frank* v. *Frank*, 305 Ill. 181, cited by the court below (R. 44–45) are not at variance with our position here. None of those cases was concerned with a power so broad and sweeping as the one in the instant case and none of them holds or even intimates that such a power would not be exercisable in accordance with its terms.

3. The question remains whether the wife and brother had interests which were substantially

adverse to a restoration of the trust properties to the grantor. The court below stated (R. 43) that if the wife and brother had the power to name themselves, or others than the grantor, as beneficiaries, that power was certainly adverse to the grantor's interests. This argument would prove too much, for it means, if sound, that any donee of a general power has a substantial adverse interest within the meaning of the statute. But a donee of a power is not a beneficiary,[3] and, as the legislative history shows, Congress was thinking of beneficiaries with more than a minor interest when it used the phrase "a substantial adverse interest." If the theory of the court below be correct, then any grantor could avoid the effect of section 166 by including the power to revest within a power of appointment and thereby defeat the known purpose of Congress.

However, even if the mere donee of a general power could be regarded as having an "adverse interest" within the intendment of Congress, the grantor herein would be taxable since the donees' interest, even if adverse, is not substantial. In the instant case, the power could be exercised only during the lifetime of the grantor while his

[3] A general power of appointment does not of itself vest any estate in the donee (*United States* v. *Field*, 255 U. S. 257; *Helvering* v. *Safe Deposit & Trust Co. of Baltimore*, 316 U. S. 56; *Gilman* v. *Bell*, *supra*; *Botzum* v. *Havana National Bank*, *supra*).

influence could make itself felt, and then only by his wife and brother. There is not any evidence in the record to justify treating either the wife or brother as a complete stranger, or to justify a disregard of "the normal consequences of family solidarity." See *Helvering* v. *Clifford*, 309 U. S. 331, 337.

One would not assume that a wife would, in defiance of her husband's wishes, exercise for her own benefit a power given her by her husband, yet the court below made that very assumption, based on no evidence and contrary to the Board's finding. The decision below is thus inconsistent with the reasoning in the *Clifford* case, and is contrary to decisions of other circuit courts of appeal, such as *Commissioner* v. *Caspersen*, 119 F. (2d) 94 (C. C. A. 3), certiorari denied, 314 U. S. 643; *Altmaier* v. *Commissioner*, 116 F. (2d) 162 (C. C. A. 6), certiorari denied, 312 U. S. 706; *Loeb* v. *Commissioner*, 113 F. (2d) 664 (C. C. A. 2), certiorari denied, 311 U. S. 710; *Fulham* v. *Commissioner*, 110 F. (2d) 916 (C. C. A. 1); and *Rollins* v. *Helvering*, 92 F. (2d) 390 (C. C. A. 8), certiorari denied, 302 U. S. 763, all of which fully support our position that a wife in a normal household who has been given rights in a trust by her husband cannot be regarded as having "a substantial adverse interest" to her husband in the realistic sense in which Congress intended that term to be understood, at least where the wife

does not have a present, existing beneficial interest.

Similarly, the grantor's brother cannot be treated as having a substantial adverse interest within the meaning of the statute. In addition to their close ties of blood, they were business associates. The grantor was president and his brother was vice president of a large corporation, stock in which constituted the assets of the trusts (R. 27; see also p. 27 in Record in companion case, *Helvering* v. *R. Douglas Stuart*, No. 49). Thus in addition to the normal brotherly regard and trust existing between them there was the friendship and confidence built on successful business association. In any event, the hard-headed necessity of maintaining a common front for the purpose of retaining the control over the corporation which their positions evidenced would probably deter the brother from disrupting the existing harmonious relationship with the grantor by naming himself beneficiary, or by naming the grantor's wife beneficiary, against the grantor's wishes.

Moreover, the grantor in this case possessed the same powers under the trusts established by his brother (see p. 29, Record in No. 49) as the brother possessed under the trusts herein. If the brother should exercise his powers herein in defiance of the grantor's wishes, the grantor would be in a position himself to do the identical thing under the trusts involved in No. 49. In these cir-

cumstances the brother would be quite unlikely to exercise his powers herein in any manner not desired by the grantor, so any adverse interest possessed by the brother is at most insubstantial. (Compare *Commissioner* v. *Warner*, 127 F. (2d) 913 (C. C. A. 9).)

Finally, the total lack of substance in any adverse interest of the wife and brother is shown by the fact that, for either to become beneficiary of these trusts in defiance of the grantor's wishes, the consent of the other would be necessary. Thus, before the brother could become beneficiary he would have to persuade the grantor's wife to join with him in the exercise of the power. And similarly the wife would have to persuade her husband's brother to assist her before she could become beneficiary. It is evident that the grantor carefully placed the power so that the chances of its being used in defiance of his wishes were too remote to be considered.

The court below seemed to suggest (R. 42) that the wife might be unwilling to exercise the power in favor of her husband because to do so would be to impoverish her children. Such considerations are not pertinent to the issue herein. Conceivably Mrs. Stuart's love for her children might make her reluctant to accede to her husband's wishes to convey the trust property back to him, but it is equally true that a corporate trustee might view with disfavor because of the loss of

fees a request of a grantor that trust assets be reconveyed to him and the trust terminated. Yet the interest of a corporate trustee is not a substantial adverse interest (Reg. 86, Art. 166–1 (b); Reg. 94, Art. 166–1 (b); Reg. 103, Sec. 19.166–1 (b); *Morton* v. *Commissioner,* 109 F. (2d) 47 (C. C. A. 7); compare *Reinecke* v. *Smith,* 289 U. S. 172). However compelling the motive may be for not revesting title to the corpus in the grantor, the grantor is taxable under the Congressional enactment unless that motive be in the form of "a substantial adverse interest in the * * * corpus."

For the foregoing reasons we submit that the finding of the Board that the wife and brother did not have a substantial adverse interest was correct and consequently the court below improperly reversed the Board. This case is a typical one where the grantor retained the controlling hand over something he had seemed to give away and consequently section 166 is applicable here with the effect of taxing the grantor on the income of the trusts.

II

SECTION 167 ALSO APPLIES

Section 167 of the Revenue Act of 1934 (Appendix, *infra*) is like section 166 except that it emphasizes the power to pay the income of the trust to the grantor instead of the power to re-

vest the corpus in the grantor. Thus, if the power resides in anyone not possessing a substantial adverse interest in the income to pay the income to the grantor or to accumulate it for future payment to him, the grantor is taxable on the income of the trusts.

Under this section the grantor is taxable on the income of the trusts herein involved, because his wife and brother could have caused the income of the trusts to be paid to him or to be accumulated for future distribution to him. The discussion under the previous heading of this brief of the broad character of the donees' power and of their lack of a substantial adverse interest is equally pertinent here and demonstrates that the conditions necessary for the application of section 167 are present.

Sections 166 and 167 often overlap. They are designed to prevent tax avoidance, and the fact that they often overlap tends to prevent a tax avoidance scheme from slipping through a hole between them. The predecessor of section 167 was section 219 (h) of the Revenue Act of 1924, reenacted as section 219 (h) of the 1926 act and as section 167 of the 1928 act. It had much the same defects as its companion provision, section 166, and consequently was amended in 1932 together with section 166. With its 1932 amendments it was reenacted in 1934.

The purpose of the 1932 amendment is outlined in S. Rep. No. 665, 72d Cong., 1st Sess., pp. 34–35 (1939–1 Cum. Bull. (Part 2), pp. 496, 521) as follows:

> SECTION 167. INCOME FOR BENEFIT OF GRANTOR.
>
> As in the case of the preceding section, attempted avoidance of the provisions of this section, relating to income held or accumulated for the grantor, has rendered expedient a change in its wording to check certain recent practices. The present law taxes the income of a trust to the grantor when in his discretion, either alone or in conjunction with a person not a beneficiary, the trust income may be held or accumulated for future distribution to him, or is or may be applied to the payment of premiums upon insurance policies on the grantor's life. Trusts have been established in which income is held or accumulated for the grantor, which fact, it is contended, removes such trusts from the operation of this section. Here again, it is not at all certain that the courts will uphold such devices; yet the statute may well be clarified to remove any doubt that the income of such trusts is to be taxed to the grantors. In the House bill, the section has been amended to provide that there shall be taxed to the grantor of a trust any part of the income of the trust which (1) is, or in the grantor's discre-

> tion may be, held or accumulated for future distribution to him, or (2) may, in the grantor's discretion, be distributed to him, or (3) is, or in the grantor's discretion may be, applied to the payment of premiums upon policies of insurance on his life. *Your committee has further amended the section so as to cover, in addition, cases in which the discretion as to the disposition of the income is in any person not having a substantial adverse interest in the disposition of such income, even though such discretionary power is not shared with the grantor.* The House bill added a subsection defining the term "in the discretion of the grantor," so as to include within the purview of the section cases in which the discretion is in the grantor in conjunction with any person not having a substantial adverse interest in the disposition of the income in question. [Italics ours.]

We submit that the instant case falls within the scope of the amendment for the grantor here bestowed on his wife and brother powers which would have permitted them to alter the trusts so as to pay the income to the grantor or accumulate it for distribution to him. As we have seen, the wife and brother did not possess a substantial adverse interest.

Article 167–1 of the regulations, both as originally adopted and as amended (Appendix, *infra*), provides that the test of taxability to the grantor is whether he has failed to divest himself, both

permanently and definitively, of every right which might, by any possibility, enable him to have such income, at some time, distributed to him, either actually or constructively. We submit that under the regulations, the grantor here is taxable upon the trust income in question, for he gave to his wife and brother the power to distribute it to him, either presently or in the future. We further submit that the regulations, as applied to the instant case, are appropriate and reasonable. *Magruder* v. *Washington, Baltimore & Annapolis Realty Corp.*, 316 U. S. 69; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375; see *Manhattan Co.* v. *Commissioner*, 297 U. S. 129, 134. Furthermore, the fact that these regulations have remained without substantial modification through the subsequent reenactments of the law (Treasury Regulations 94, Art. 167–1, promulgated under the Revenue Act of 1936, Sec. 167; Treasury Regulations 101, Art. 167–1, promulgated under the Revenue Act of 1938, Sec. 167; Treasury Regulations 103, Sec. 19.167–1, promulgated under the Internal Revenue Code, Sec. 167) affords additional basis for their validity. *Taft* v. *Commissioner*, 304 U. S. 351; *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; *Morrissey* v. *Commissioner*, 296 U. S. 344, 355.

Since section 167 was enacted to prevent tax avoidance through the trust device, it should be construed so that it may effectuate its intended

purpose. As the court said in *Kaplan* v. *Commissioner*, 66 F. (2d) 401, 402 (C. C. A. 1), with reference to the section of an earlier act corresponding to section 167 of the Revenue Act of 1934:

> We see no occasion for refinement of construction against the government. We think the statute means that if under any circumstances or contingencies any part of the accumulated income might inure to the benefit of the grantor such portion of the income is taxable to him.

Under that interpretation of the law, the grantor in the instant case would be accountable for the trust income here involved. The *Kaplan* case has been cited with approval in later cases such as *Helvering* v. *Evans*, *supra*, and *Altmaier* v. *Commissioner*, *supra*.

And in *Kent* v. *Rothensies*, 120 F. (2d) 476 (C. C. A. 3), certiorari denied, 314 U. S. 659, the court said (p. 478):

> * * * when we consider that Congress was dealing with the problem of eliminating the use of the trust device as a means of avoiding surtaxes we can hardly think that it intended to weaken the effectiveness of the remedy it was devising by making it applicable only when the right of a grantor to accumulations of trust income was vested or unconditional. * * *

See also *Commissioner* v. *Caspersen*, *supra*; *Loeb* v. *Commissioner*, *supra*; *Rollins* v. *Helver-*

ing, supra; White v. *Higgins,* 116 F. (2d) 312, 318 (C. C. A. 1); *Irish* v. *Commissioner,* 129 F. (2d) 468 (C. C. A. 3); *Phipps* v. *Helvering,* 124 F. (2d) 288 (App. D. C.).

In the circumstances we submit that the income of the trust is taxable to the grantor under section 167.

III

AS A FURTHER ALTERNATIVE, THE INCOME OF THE TRUSTS IS TAXABLE TO THE GRANTOR UNDER SECTION 22 (A) OF THE REVENUE ACT OF 1934

In the court below we also contended that this case is controlled by *Helvering* v. *Clifford,* 309 U. S. 331, but our contention was overruled. We submit that this was error and that the taxpayer remained in substance the owner of the trusteed properties and taxable upon the income therefrom under the rule of the *Clifford* case.

In that case, the grantor was held taxable under section 22 (a) of the Revenue Act of 1934, upon trust income paid to his wife, as beneficiary, where the trust was to continue for a short term of five years or until prior death of the taxpayer or his wife, and upon termination of the trust the corpus was to go to the grantor or his estate but any undistributed net income was to be treated as the property of the wife. The grantor was the sole trustee with broad powers of control over the trust property. The

reason for the decision was that the grantor retained so many of the attributes of ownership as to justify the conclusion that he continued to be the owner of the trust properties within the meaning of section 22 (a).

The rule in the *Clifford* case has not been restricted to the precise facts there presented and it has been applied in many other cases presenting a variety of factual backgrounds. Some of these cases are as follows: *Hormel* v. *Helvering*, 312 U. S. 552; *Helvering* v. *Horst*, 311 U. S. 112; *Harrison* v. *Schaffner*, 312 U. S. 579; *Commissioner* v. *Buck*, 120 F. (2d) 775 (C. C. A. 2); *Commissioner* v. *Brown*, 122 F. (2d) 800 (C. C. A. 3); *Jacobs* v. *Commissioner*, 129 F. (2d) 99 (C. C. A. 5); *Cox* v. *Commissioner*, 110 F. (2d) 934 (C. C. A. 10), certiorari denied, 311 U. S. 667; *Whiteley* v. *Commissioner*, 120 F. (2d) 782 (C. C. A. 3), certiorari denied, 314 U. S. 657; *Commissioner* v. *Berolzheimer*, 116 F. (2d) 628 (C. C. A. 2); *White* v. *Higgins*, *supra*; *Helvering* v. *Elias*, 122 F. (2d) 171 (C. C. A. 2), certiorari denied, 314 U. S. 692; *McKnight* v. *Commissioner*, 123 F. (2d) 240 (C. C. A. 8).

Indeed, in *Helvering* v. *Fuller*, 310 U. S. 69, 76, this Court indicated that where the grantor retained substantial control over the trust property he might be taxable under the rule in the *Clifford* case even though the trust was for a

term of ten years at the expiration of which the corpus was to be transferred to his divorced wife.

In *Commissioner* v. *Buck, supra,* the Second Circuit held the grantor accountable for the income of a family trust where he reserved power to manage the corpus and also the right to change the provisions as to disposition of income or principal, provided, however, that he could not direct payment to himself. In so holding, the Court expressed the view that where the grantor retains sufficient control over the trust properties he may be taxed under the rule of the *Clifford* case even though the trust is not for a short term only.

In *Commissioner* v. *Brown, supra,* the facts are similar to those in the *Buck* case and the court remanded the case to the Board for further consideration in the light of the *Clifford* case as the taxpayer had not had an opportunity to adduce evidence on this point at the Board hearing.

In *Jacobs* v. *Commissioner, supra,* the Fifth Circuit upheld the Board's conclusion that the grantor was taxable under the *Clifford* rule where by the joint action of taxpayer and his wife, the trust funds might be devoted to any use to which a private owner of the assets might put them, or the trust could immediately be terminated and the property conveyed to the settlor. The court said (p. 100):

> Where such complete dominion over a trust is vested in the settlor and his wife,

to hold that the power of joint control in the wife relieves the settlor of the burdens of the tax upon the income produced would be "to let mere formalism obscure the normal consequences of family solidarity, and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance."

In the instant case the record supports the conclusion that the taxpayer's control over the trusteed properties was not substantially reduced by the transfers in trust. These properties were shares of stock in a corporation of which taxpayer was president and his brother was first vice president. The trustees named in each indenture were taxpayer, his wife, and brother. They were given broad control over the properties, including the power to sell and to vote or otherwise act with respect thereto, and if taxpayer was not satisfied with the control exercised by his cotrustees over the voting power, he was empowered by article Eighth of the trust instrument to buy back the stock. He could direct reinvestments. For a period of fifteen years the trustees were to pay over to each child of the grantor so much of the income of his trust as they should deem advisable and add the balance to corpus. After the expiration of the fifteen year period, the children were to get the entire income. Upon death of the beneficiary, the corpus was to go to his issue. The grantor's wife

and brother were given power to change the beneficiaries and to amend the indentures in any respect. (See trust indenture, R. 15–19.)

In the circumstances, we submit that here, as in the *Clifford* case, the grantor retained enough of the attributes of ownership of the trust funds to justify taxing the income to him under Section 22 (a). The situation presented by the instant case is that of a wealthy man who had been giving allowances to his children and who by creating the trusts gave formality to his wish to provide an income for them, reserving complete control over the disposition of corpus and income either directly or through the instrumentality of his wife and brother, who, as we have seen, had no interest which would be adverse to carrying out the purposes of the grantor. Indeed, the brother executed similar trusts in favor of his own children and conferred upon his wife and brother (this grantor) the power to change them in any respect. This heightens the probability that each brother would have exercised the power only in accordance with the wishes of the other; and the record fully supports the conclusion of the Board of Tax Appeals that the interests of both the wife and the brother were in harmony with and not antagonistic to those of the grantor.

We submit that the instant case falls within the scope of the *Clifford* case and other decisions following it, cited above. Moreover, the result

would not be altered even if it should be thought, contrary to our views expressed herein, that no changes could be made in the trusts which would divert the corpus or income to the grantor within the meaning of sections 166 or 167. *Commissioner* v. *Buck, supra; Commissioner* v. *Brown, supra;* see *Helvering* v. *Fuller, supra;* cf. *Estate of Sanford* v. *Commissioner,* 308 U. S. 39.

CONCLUSION

The judgment of the court below should be reversed.

Respectfully submitted.

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APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * *

SEC. 166. REVOCABLE TRUSTS.

Where at any time the power to revest in the grantor title to any part of the corpus of the trust is vested—

(1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or

(2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom,

then the income of such part of the trust shall be included in computing the net income of the grantor.

SEC. 167. INCOME FOR BENEFIT OF GRANTOR.

(a) Where any part of the income of a trust—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23 (o), relating to the so-called "charitable contribution" deduction);

then such part of the income of the trust shall be included in computing the net income of the grantor.

(b) As used in this section, the term "in the discretion of the grantor" means "in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question."

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 22. (a)-1. *What included in gross income.*—Gross income includes in general

compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. * * *

* * * * * * *

ART. 166–1 [as originally promulgated]. *Trusts in the corpus of which the grantor retains an interest*—(*a*) *Scope.*—Section 166 prescribes that the income, or any part of the income, of certain trusts shall be taxed, not to the trustee nor to the beneficiaries, but to the grantor because of the fact that the grantor has retained a certain interest in the property of the trust. This article deals with the taxation of such income. The term "corpus," as used in this article, means any part or the whole of the property, real or personal, constituting the subject matter of the trust.

(*b*) *Test of taxability to the grantor.*—The sufficiency of the grantor's retained interest in the corpus resulting in the taxation of its income to the grantor is determined by a single test, namely, whether the grantor has failed to divest himself, permanently and definitively, of every right which might by any possibility enable him once more to possess and enjoy in title the trust corpus. For the purposes of this article the sufficiency of the grantor's retained interest in the corpus is not affected by the fact that the grantor has provided that the

right to cause the title to the corpus to revest in himself is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a substantial interest in the corpus or income therefrom adverse to the grantor.

If the grantor has retained any such interest in the corpus he is taxable on the income therefrom regardless of—

(1) how great or how small, how remote or how contingent the interest may be;

(2) whatever the nature of interest retained may be; whether the interest retained is vested, contingent, in reversion, or otherwise; whether conditioned on the precedent giving of notice, or on the elapsing of a period of years, or on the happening of a specified event; whether taken by appointment, or by designation in the trust instrument, or merely by virtue of the grantor not conveying his whole estate in the corpus, or otherwise;

(3) the time or times at which such interest will revest the title in the grantor in possession and enjoyment, whether within or without the taxable year, whether or not the time be fixed, determinable or certain to come;

(4) whether, if the revesting in the grantor of title to the corpus is in any way dependent upon the act of anyone, that person be the grantor, or any person not having a substantial interest in the corpus or income therefrom adverse to the grantor, or both. A bare legal interest, such as that of a trustee, is never substantial and never adverse;

(5) when the trust was created.

For example, a grantor has not permanently or definitively divested himself of

title to the corpus if he has placed it in trust for his son, John,

(A) for the term of three years, at the end of which time the trust might be extended for a like period at the option of the grantor and successively thereafter, but in the absence of such an extension the title is once more to revest in the grantor in possession and enjoyment; or

(B) for the term of a year and a day, then to be distributed to whomsoever the wife of the grantor shall by deed appoint (the wife not being a beneficiary, but being empowered to appoint to anyone other than herself); or,

(C) for the term of the grantor's life, then to be distributed to John, the grantor reserving, however, the right to alter, amend, or revoke any provision of the trust instrument, upon notice of a year and a day.

In these typical cases the grantor has provided that the title shall or may once more revest in himself by the retention of an interest (executory or otherwise) capable of vesting title in the grantor in possession and enjoyment, in (A) upon the expiration of the trust period if the grantor does not exercise his option to extend the trust, in (B) upon the designation of the grantor as distributee, by a person not substantially and adversely interested, and in (C) upon the revocation of the trust instrument or an alteration or amendment thereof, resulting in the designation of the grantor as distributee.

Thus the inclusion within the scope of section 166 of any trust is based on the fact that the grantor has retained an interest in the corpus which once more will, or may

possibly, vest the title in him in possession and enjoyment. Section 166 makes no distinction between a "revocable trust" (so called because of a provision in the trust instrument permitting some person at some time or in some manner to terminate the trust) and an "irrevocable trust" as such. Some "revocable trusts" are within the scope of section 166, not however by reason of the element of revocability, but because the grantor has reserved the requisite interest in the trust corpus, whether the vesting in title of such interest depends on revocation or otherwise. If no such interest has been retained, a "revocable trust" is not within the scope of section 166, even though the particular trust estate is subject to revocation by the grantor.

If the grantor strips himself permanently and definitively of every such interest in the corpus retained by him, the income of the trust realized after the effective date of such divesting is not taxable to the grantor but is taxable as provided in sections 161 and 162.

(*c*) *Income and deductions.*—If, as to any of the corpus, the test of taxability to the grantor is satisfied, the gross income of such corpus shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to such corpus as he would have been entitled to had the trust not been created.

ART. 166–1 [as amended by T. D. 4629, XV–1 Cum. Bull. 140, 141 (1936), and T. D. 4759, 1937–2 Cum. Bull. 117, 118]. *Trusts, with respect to the corpus of which, the grantor is regarded as remaining in substance the owner.*—(*a*) If the grantor of a trust is regarded, within the meaning

of the Act, as remaining in substance the owner of the corpus thereof, the income therefrom is not taxable in accordance with the provisions of sections 161, 162, and 163 but remains attributable and taxable to the grantor. This article deals with the taxation of such income. As used in this article, the term "corpus" means any part or the whole of the property, real or personal, constituting the subject matter of the trust.

(*b*) Section 166 defines with particularity instances in which the grantor is regarded as in substance the owner of the corpus by reason of the fact that he has retained power to revest the corpus in himself. For the purposes of this article the grantor is deemed to have retained such power if he, or any person not having a substantial interest in the corpus or the income therefrom adverse to the grantor, or both, may cause the title to the corpus to revest in the grantor. If the title to the corpus will revest in the grantor upon the exercise of such power, the income of the trust is attributed and taxable to the grantor regardless of—

(1) whether such power or ability to retake the trust corpus to the grantor's own use is effected by means of a power to revoke, to terminate, to alter or amend or to appoint;

(2) whether the exercise of such power is conditioned on the precedent giving of notice, or on the elapsing of a period of years, or on the happening of a specified event;

(3) the time at which the title to the corpus will revest in the grantor in possession and enjoyment, whether such time is within the taxable year or not, or whether such time be fixed, determinable, or certain to come;

(4) whether the power to revest in the grantor title to the corpus is in the grantor, or in any person not having a substantial interest in the corpus or income therefrom adverse to the grantor, or in both. A bare legal interest, such as that of a trustee, is never substantial and never adverse;

(5) when the trust was created.

But the provisions of section 166 are not to be regarded as excluding from taxation to the grantor the income of other trusts, not specified therein, in which the grantor is, for the purposes of the Act, similarly regarded as remaining in substance the owner of the corpus. The grantor is regarded as in substance the owner of the corpus, if, in view of the essential nature and purpose of the trust, it is apparent that the grantor has failed to part permanently and definitively with the substantial incidents of ownership in the corpus.

In determining whether the grantor is in substance the owner of the corpus, the Act has its own standard, which is a substantial one, dependent neither on the niceties of the particular conveyancing device used, nor on the technical description which the law of property gives to the estate or interest transferred to the trustees or beneficiaries of the trust. In that determination, among the material factors are: the fact that the corpus is to be returned to the grantor after a specific term; the fact that the corpus is or may be administered in the interest of the grantor; the fact that the anticipated income is being appropriated in advance for the customary expenditures of the grantor or those which he would ordinarily and naturally make; and any other circumstances bearing on the impermanence and indefi-

niteness with which the grantor has parted with the substantial incidents of ownership in the corpus.

Thus the grantor is regarded as being in substance the owner of the corpus if, in any case, the trust amounts to no more than an arrangement whereby the grantor, in the ordering of his affairs, finds it expedient to entrust for a period the title to, and custody or management of, certain of his property to a trustee, the income from such property to be used by the trustee during such period to make those expenditures which the grantor would customarily or ordinarily or naturally make and to which the grantor chooses to commit himself in advance, while the corpus is to be held intact, for return in due course to the grantor. In such a case, it is immaterial that, at the time of the creation of the trust, an irrevocable disposition or consummated gift was made of those property rights which consist of the right to the expected future income of the corpus for the specified period. On the other hand, if the grantor, incident to a definitive and permanent disposition of certain of his property, creates the trust in order to conserve the property, not for himself but for the donees, who will ultimately enjoy it, the provisions of sections 161, 162, and 163 are applicable.

(*c*) For example, a grantor is regarded as remaining in substance the owner of the corpus of the trust, if he has placed it in trust for his son, John.

(A) for the term of three years, at the end of which time the trust might be extended for a like period at the option of the grantor and successively thereafter, but in the absence of such an extension the title is

once more to revest in the grantor in possession and enjoyment; or

(B) for the term of a year and a day, then to be distributed to whomsoever the wife of the grantor shall by deed appoint (the wife not having a substantial adverse interest in the disposition of the corpus or the income therefrom); or

(C) for the term of the grantor's life, then to be distributed to John, the grantor reserving, however, the right to alter, amend, or revoke any provision of the trust instrument, upon notice of a year and a day.

In these typical cases the grantor is regarded as having retained the substantial incidents of ownership with respect to the income-producing property since the corpus will or may once more revest in himself in (A) upon the expiration of the trust period if the grantor does not exercise his option to extend the trust, in (B) upon the designation of the grantor as distributee, by a person not substantially and adversely interested, and in (C) upon the revocation of the trust instrument or an alteration or amendment thereof, resulting in the designation of the grantor as distributee.

(*d*) If the grantor is regarded as remaining in substance the owner of the corpus the gross income of such corpus shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to the corpus as he would have been entitled to had the trust not been created.

If the grantor strips himself of the substantial incidents or attributes of ownership in the corpus retained by him so that he ceases to be regarded as in substance the

owner of the corpus, the income thereof realized after the effective date of such divesting is not taxable to the grantor but is taxable as provided in sections 161, 162, and 163.

A person may have an interest that is both substantial and adverse to the grantor in the disposition of only part of the corpus or the income therefrom. If the power to revest title in the grantor is vested in him in conjunction with such person, or is vested solely in such person, there is to be excluded in computing the net income of the grantor only the income of such part.

ART. 167-1 [as originally promulgated]. *Trusts in the income of which the grantor retains an interest.*—(*a*) *Scope.*—Section 167 prescribes that the income, or any part of the income, of certain trusts shall be taxed to the grantor, not because the grantor has retained a certain interest in the *corpus* of the trust (as in section 166), but because of his retention of a certain interest in the *income* of the trust. This article deals with the taxation of such income. The term "income," as used in this article, means any part or the whole of the income of the trust.

(*b*) *Test of taxability to the grantor.*—The test of the sufficiency of the grantor's retained interest in the trust income, resulting in the taxation of such income to the grantor, is whether the grantor has failed to divest himself, permanently and definitively, of every right which might, by any possibility, enable him to have the income, at some time, distributed to him, actually or constructively. Such a distribution to the grantor occurs if the income is paid to him or to another according to the grantor's direction or if, though paid to another pursu-

ant to the terms of the trust, the benefit of the income inures to the grantor. The income so inures if it is or may be applied in satisfaction of a legal obligation of the grantor, does or may increase his net worth, does or may in any way enrich him, or does or may enable him in any way to enjoy, in substance, such income. Such a distribution also occurs if the income is applied in payment of premiums upon policies of insurance on the grantor's life.

For the purposes of this article, the sufficiency of the grantor's retained interest in the income is not affected by the fact that the grantor has provided that the right to so effect or direct the distribution of income is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a substantial interest in the income adverse to the grantor.

If the grantor has retained any such interest in the income, such income is taxable to the grantor regardless of—

(1) whether it may be distributed currently or accumulated for future distribution;

(2) whether such distribution, either current or subject to accumulation, is fixed by the trust instrument or is dependent on an exercise of discretion;

(3) whether, if such distribution is in any way effected by or dependent on an exercise of discretion, the person exercising the discretion is the grantor or a person not having a substantial interest in the income adverse to the grantor, or both. A bare legal interest, such as that of a trustee, is never substantial and never adverse;

(4) whether, if such distribution results in the inuring of benefits to the grantor from the application of the income in satisfaction of his legal obligation, such obligation is to pay a debt, to support dependents, to pay alimony, to furnish maintenance, and support or otherwise;

(5) the time or times of such distribution, whether within or without the taxable period, whether conditioned on the precedent giving of notice, or on the elapsing of an interval of time, or on the happening of a specified event, or otherwise;

(6) when the trust was created.

Thus the inclusion of any trust within the scope of section 167 is based on the fact that the grantor has retained an interest in the income therefrom by which he is, or may be enabled at some time, to receive its benefits. If the grantor strips himself permanently and definitively of every such interest retained by him, the income of the trust realized after such divesting takes effect is not taxable to the grantor, but is taxable as provided in sections 161 and 162.

(*c*) *Income and deductions.*—If, as to any of the income, the test of taxability to the grantor is satisfied, such income shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to such income as he would have been entitled had such income been distributable currently to him.

ART. 167–1 [as amended by T. D. 4759, *supra*, and T. D. 4860, 1938–2 *Cum. Bull.* 184]. *Trusts in the income of which the grantor retains an interest.*—(*a*) *Scope.*—Section 167 prescribes that the income, or any part of the income, of certain trusts shall be taxed to the grantor, not because

the grantor has retained a certain interest in the *corpus* of the trust (as in section 166) but because of his retention of a certain interest in the *income* of the trust. This article deals with the taxation of such income. The term "income," as used in this article, means any part or the whole of the income of the trust.

(*b*) *Test of taxability to the grantor.*—The test prescribed by the Act as to the sufficiency of the grantor's retained interest in the trust income, resulting in the taxation of such income to the grantor, is whether he has failed to divest himself, both permanently and definitively, of every right which might, by any possibility, enable him to have such income, at some time, distributed to him, either actually or constructively. Such a distribution to the grantor occurs within the meaning of section 167 if the income is paid to him or to another in obedience to his direction or if the income is applied in payment of premiums upon policies of insurance on the grantor's life.

For the purposes of this article, the sufficiency of the grantor's retained interest in the income is not affected by the fact that the grantor has provided that the right to so effect or direct the distribution of income is, or may at some future time be, vested in any person (either alone or in conjunction with the grantor) not having a substantial interest in the income adverse to the grantor.

If the grantor has retained any such interest in the income, such income is taxable to the grantor regardless of—

(1) whether it may be distributed currently or accumulated for future distribution;

(2) whether such distribution, either current or subject to accumulation, is fixed by the trust instrument or is dependent on an exercise of discretion;

(3) whether, if such distribution is in any way effected by or dependent on an exercise of discretion, the person exercising the discretion is the grantor or a person not having a substantial interest in the income adverse to the grantor, or both. A bare legal interest, such as that of a trustee, is never substantial and never adverse;

(4) the time or times of such distribution, whether within or without the taxable period, whether conditioned on the precedent giving of notice, or on the elapsing of an interval of time, or on the happening of a specified event, or otherwise;

(5) when the trust was created.

Thus the inclusion of any trust within the scope of section 167 is based on the fact that the grantor has retained an interest in the income therefrom by which he is, or may be enabled at some time, to receive its benefits. But the provisions of section 167 are not to be regarded as excluding from taxation to the grantor the income of other trusts, not specified therein, in which the grantor is, for the purposes of the Act similarly regarded as remaining in substance the owner of the trust income. If, for example, trust income is applied in satisfaction of the grantor's legal obligation whether to pay a debt, to support dependents, to pay alimony, to furnish maintenance and support, or otherwise, such income is in all cases taxable to the grantor.

If the grantor strips himself permanently and definitively of every such interest retained by him, the income of the trust re-

alized after such divesting takes effect is not taxable to the grantor but is taxable as provided in sections 161 and 162.

A person may have an interest that is both substantial and adverse to the grantor in the disposition of only part of the income. There is to be excluded in computing the net income of the grantor only that part of the trust income in the disposition of which such person has a substantial interest adverse to the grantor.

(*c*) *Income and deductions.*—If, as to any of the income, the test of taxability to the grantor is satisfied, such income shall be included in the gross income of the grantor, and he shall be allowed those deductions with respect to such income as he would have been entitled had such income been distributable currently to him.

U. S. GOVERNMENT PRINTING OFFICE: 1943

FILE COPY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No. ~~1054~~ 48

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

JOHN STUART,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

GEORGE I. HAIGHT,
WILLIAM D. MCKENZIE,
HERBERT POPE,
Counsel for Respondent.

April 7, 1942.

THE BURTHORP-WARREN PRINTING COMPANY, 211 WEST JACKSON, CHICAGO

IN THE

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GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

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The Petitioner in this case contends that the decision below is in conflict with decisions in other cases in other Circuit Courts of Appeal. The truth is that Petitioner's contention in this case carries the "family solidarity" argument to such an extreme that it defeats itself. There is no other case which demonstrates so conclusively that even in tax cases the line must be drawn somewhere short of complete absurdity.

In order to revest the grantor with the required ownership or control of the trust property, Petitioner is compelled, regardless of the law of Illinois, to give a construction to paragraph "Ninth" of each trust that will make the two trustees therein mentioned the individual owners of the property free from any fiduciary obligation. Then,

according to Petitioner's argument, they may, at the request of the grantor, give the trust property back to him. It is contended by Petitioner here, as it was in the Court below, that these two trustees, the wife and the brother, while not named as beneficiaries, have the power to make themselves, or to make the grantor, beneficiaries of the trust, and thus to turn the trust property back to the grantor or take it for themselves or give it to anyone else as they may see fit. Petitioner then concludes that, in view of this unlimited power in the two trustees and "in the light of the business and family relationships," (Petitioner's brief, p. 9), the complete ownership of the wife and brother becomes the ownership of the grantor, and yet asserts that the ownership of the wife and brother is not an adverse interest.

What becomes of the gift tax under this theory Petitioner does not say. Certainly a man could not make a taxable gift to his wife or his brother or to anyone else in his family group if such a theory were to prevail. At least there could be no gift until the man and his wife or his brother fell out, and only a person who was a sworn enemy of the family group could become a real trustee.

Seriously, does the Petitioner contend that the two trustees could take this trust property for their own and then after that give it back to the grantor without a gift tax? Or could they give it, as the Board Member suggested, to one of the counsel in the case without committing any breach of trust? The courts in Illinois, if proper appeal were made to them, would have the right to say something about that.

It is certain that a chancery court in Illinois would protect the named beneficiaries in these trusts if the two trustees undertook to appropriate the trust property for the benefit of themselves or the grantor or others. The highest court in Illinois would not construe paragraph

"Ninth" of these trusts as giving to the trustees an unlimited power to change beneficiaries, and it would not recognize any changes which were not the result of the exercise of the independent judgment of the two trustees. We submit that the Circuit Court of Appeals was right in its conclusion regarding the application of the law of Illinois in this case, and that the development of the federal common law in this country will not be impeded nor the "creative art" displayed in the *Clifford* case, 309 U. S. 331, impaired, if the petition for certiorari in this case be denied.

It is clear that paragraph "Eighth" of each trust, which provides that the grantor shall have the right to withdraw securities from the trust only if he replaces them with other securities of equal market value, prevents a modification of the trust under paragraph "Ninth" which would return the trust property to the grantor without the substitution of such other securities. Such a modification of the trust by the two trustees would clearly constitute a breach of trust. And it does not seem possible that such a breach of trust could be avoided if the two trustees first took the property for themselves, terminating the trust, and then returned the trust securities to the grantor. Certainly if that could be done the two trustees would in any event subject themselves to a gift tax larger than the income tax now involved. By returning the trust securities to the grantor they must be either fiduciaries committing a breach of trust or owners subjecting themselves to a gift tax; and in either case Section 166 of the Revenue Act would not apply.

It is just as clear that if the trusts are to continue they must be continued in accordance with their express terms. They are not short term trusts. They are intended for the benefit of the grantor's children, but contain provisions which direct how the property shall be held in the

event of the death of the named beneficiaries and when and to whom the trust property shall finally be distributed. There are no provisions for termination at the discretion of the trustees, and the trustees are required to act for the benefit of the beneficiaries. The grantor himself is excluded as a beneficiary and as an owner by the terms of paragraph "Eighth," and the named beneficiaries, and all other persons who conceivably might become beneficiaries, including, according to Petitioner, the two trustees, have interests adverse to the grantor. The beneficiaries are entitled at all times to insist that the trustees perform their duties as trustees. The two trustees mentioned in paragraph "Ninth" have no power to delegate any of their powers or duties to the grantor, and the named beneficiaries are entitled to appeal to a court of chancery to prevent arbitrary action by the two trustees under the powers conferred upon them by paragraph "Ninth," and to prevent any action which is not consistent with the purpose of the trusts and the intention of the grantor as shown by the trusts themselves and the testimony of the grantor.

In the Court below it was contended that the beneficiaries probably would not appeal to a court of chancery even if the trust property were returned to the grantor. But the existence of an adverse interest is not to be determined by speculation as to what the person having such an interest might do to protect it. The beneficiaries do in fact have enforceable interests adverse to the grantor, and the attempt of Petitioner to escape from that conclusion results only in giving adverse interests to the two trustees by making them in effect the owners of the trust property. As stated at the beginning, this contention of Petitioner defeats itself because it creates merely another adverse interest—an interest in the wife and brother—which eliminates the application of Section 166 and

leaves no room for argument under Section 167 or Section 22 (a) of the Revenue Act.

In none of the cases cited by Petitioner is the decision based upon the assumption of a breach of trust by trustees or the unwillingness of beneficiaries to protect their interests. It is not necessary, therefore, to refer in detail to the cases cited in order to show that the decision of the Court of Appeals in this case is not in conflict with any other decision anywhere.

Respectfully submitted,

GEORGE I. HAIGHT,
WILLIAM D. MCKENZIE,
HERBERT POPE,
Counsel for Respondent.

April 7, 1942.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 48

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

JOHN STUART,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT.

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Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENT.

Opinions.

The opinion of the Circuit Court of Appeals is reported in 124 F. (2d) 772. The memorandum opinion of the United States Board of Tax Appeals is not reported officially.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered December 19, 1941 (R. 49). The petition for writ of certiorari was filed March 19, 1942 and granted April 27, 1942. The jurisdiction of this Court is conferred by Section 240(a) of the Judicial Code as amended.

Summary of Argument.

In view of the language of the trusts and the evidence as to the intent of the grantor to make provision for his children, there is no provision in the Revenue Act of 1934 which justifies the taxation of the grantor on account of the income most of which was distributed to them and the balance of which was accumulated for the benefit of them and their issue.

Sections 166(2), 167 and 22(a) do not sustain the Government's contention in this case. Section 22(a), as interpreted in the *Clifford* case, 309 U. S. 331, is the broadest of these and if it makes the income of the beneficiaries in this case taxable to the grantor, the Government does not need the other sections which, without the help of Section 22(a) as interpreted by this Court, afford no basis for taxing the income of these trusts to the grantor. As to 22(a) the *Clifford* case falls far short of supporting the Government's contention, and the *Richardson* case, 121 F. (2d) 1, shows that, if any persons other than the beneficiaries were taxable under the *Clifford* doctrine, it would have been the grantor's wife and brother, not the grantor himself. Even if we accepted the Government's contention that the wife and brother, by reason of Paragraph Ninth of the trusts, became the real owners of the trust property and had no fiduciary duty to the beneficiaries, then the wife and brother, rather than the grantor, should have been taxed, so that the Government's own contention and theory of the case disposes of any tax against the grantor.

Paragraph Ninth must be construed with all the other provisions of the trusts, and no court would construe it as conferring a power to defeat the expressed purpose of the trusts to make permanent provision for the grantor's children and issue. If we can imagine the grantor's wife and brother attempting to terminate the trusts and turning over the trust property to the grantor, it is clear that the courts of Illinois, if appealed to, would prevent such a breach of duty.

ARGUMENT.

I.

The Provisions of the Trusts and the Evidence Do Not Support the Contention of the Government in This Case.

Nothing could illustrate better than does this case the extreme lengths to which the Revenue Bureau has carried the allocation of income for tax purpose to persons who are not the named beneficiaries of income in trust instruments. Here we have at least two intimate family groups instead of just one, and the families of the grantor's married daughters should make two more. The Government's contention is that, under Paragraph Ninth of the trusts, the wife and brother of the grantor, who are named as trustees, have been granted a power which gives them substantial ownership of the trust property, and that it may be assumed that they would or at least that they "could have transferred the corpus back to the grantor without interference by a court of equity." (Br. 17.) The conclusion is that therefore the grantor, in view of his relationship to his wife and brother, should be taxed on the income of the trusts which long before, in 1934 and 1935, had been paid to the grantor's children. What becomes of the gift tax on such an assumption is not disclosed.

The first thing to notice in regard to this contention is that, under the decision of the Circuit Court of Appeals for the Second Circuit in the case of *Richardson* v. *Commissioner*, 121 F. (2d) 1 (petition for certiorari denied by this court), the wife and brother might also have been taxed on the same income as the substantial owners of the trust property. The result is that, under the Revenue Acts and the decisions of the courts, the named beneficiaries

who received the income could be taxed, the wife and the brother could be taxed, and now, it is claimed, the grantor also could be taxed on the same income. It is not claimed apparently that they could all be taxed by the federal government at one and the same time, but, in such a case, if they lived in different states having income taxes, they might all be taxed at the same time, and the income taxes could easily amount to more than the income.

The three trusts in this case were made in 1930, long before the theories now set forth in the Government brief were thought of or suggested, and there is nothing in the evidence in this case to support the assumption that Paragraph Ninth was designed to enable the grantor to recover or control the trust property, to change the beneficiaries or to terminate the trusts. When John Stuart created these trusts he thought it wise to have some one outside his own intimate family group to assist in the supervision of the distribution of the income intended for his children. That is not an unusual attitude. Many parents believe that persons outside the intimate family group may be able better to train their children in some matters than they can do it themselves. This is particularly true in connection with money matters. A father may reasonably wish to make a provision for children which makes them independent so far as he is concerned, and yet have someone else outside the intimate family group exercise some supervision over their conduct and their expenditures. There is nothing in the record in this case which discloses any other reason for giving the brother, together with the wife, the broad powers conferred upon them by the trusts. There is no evidence to support the views which the Government attorneys are required now to imagine. Surely, it is not necessary, in order to accomplish what this grantor had in mind, to name an entire stranger as a trustee in order to avoid the arguments which Government attorneys now make. A grantor is entitled in such a case to appoint

a trustee or other person upon whom he can rely to exercise the desired supervision over the welfare of his own children. He is not required to risk their welfare in order to satisfy revenue agents that the trustee appointed probably will not do what the grantor would like to have him do in the exercise of the independent judgment required of him as a trustee.

On March 31, 1930, the respondent executed three trust agreements, one for his daughter who had just been married, Joan Stuart Scudder, one for another daughter, Ellen, who was about to be married and whose married name is Ellen Stuart Poole, and one for his son, John. In 1934, the first year herein involved, the married daughters were 30 and 27 years of age, respectively, and the son was 22 years old (R. 12, 13).

The respondent created the trusts because he felt that the daughters ought to be made independent so that they could run their homes in a reasonable way. He had been giving his children allowances, a plan of which he did not approve, particularly after marriage (R. 22, 23). His reason for appointing his wife, Ellen Shumway Stuart, and his brother, R. Douglas Stuart, as trustees with himself was that he knew that they shared his point of view in regard to the children, their needs, and how he wanted them to live, and that they would be just as "hard-boiled" in dealing with the children as he would be. He thought that the children's interests would be better served and protected by having them as trustees than by having a corporate trustee. They knew why the trusts were created and that it was done entirely for the benefit of the children. The respondent felt sure that as trustees they would resist any attempt by anyone to change that objective (R. 24, 25).

The respondent's net worth at the time when the trusts were established, outside of the property which he put in the trusts, was something over $4,000,000. The property

in the trusts was worth about $575,000 (R. 26). Each of the trusts comprised 700 shares of common stock of Quaker Oats Company, of which the petitioner was president (R. 27).

In creating the three trusts the respondent made the same provision for each of his children. A copy of one of the three trusts is reproduced in full (R. 15-19). For the first fifteen years the trustees were to pay to the child designated as the beneficiary of the particular trust so much of the net income as they in their discretion should deem advisable and to add any undistributed income to the principal of the trust. After fifteen years the trustees were to pay the entire net income to said child (Par. Fourth, R. 16). Upon the death of the child the trustees were to pay over the principal of the trust to the child's issue then living, or, if there were no such issue, then to the issue of the respondent then living, or, if there were no such issue then living, then in equal shares to Princeton University and the University of Chicago (Pars. Fifth and Sixth, R. 16, 17). The trustees were given the usual broad powers of management and administration (Par. Second). There was a spendthrift clause (Par. Seventh), a clause exonerating the trustees from liability except for fraud or willful mismanagement (Par. Tenth), a provision appointing a trust company as a co-trustee if two of the trustees should resign (Par. Eleventh), and a provision that the trust was to be governed by the laws of the State of Illinois (Par. Fifteenth).

The petitioner reserved no right to revoke the trusts, nor to change their provisions, nor was he a beneficiary of any of the trusts. He reserved a right to withdraw property from each of the trusts by substituting therefor other property satisfactory to the trustees and of a market value at least equal to that of the property so withdrawn. He also gave the other trustees, his wife and brother, the right to alter, change or amend the trust agreements. These

provisions are contained in paragraphs Eighth and Ninth, which provide (R. 17, 18):

> "Eighth. The Donor reserves and shall have the right at any time and from time to time to direct the Trustees to sell the whole of the Trust Fund, or any part thereof, and to reinvest the proceeds in such other property as the Donor shall direct. The Donor further reserves and shall have the right at any time and from time to time to withdraw and take over to himself the whole or any part of the Trust Fund upon first transferring and delivering to the Trustees other property satisfactory to them of a market value at least equal to that of the property so withdrawn.
>
> "Ninth. During the life of the Donor, the said Ellen Shumway Stuart and the said Robert Douglas Stuart, or the survivor of them, shall have full power and authority, by an instrument in writing signed and delivered by them or by the survivor of them to the Trustees, to alter, change or amend this Indenture at any time and from time to time by changing the beneficiary hereunder, or by changing the time when the Trust Fund, or any part thereof, or the income, is to be distributed, or by changing the Trustees, or in any other respect."

On August 3, 1935, each of the trust agreements was amended by eliminating paragraph Eighth and changing paragraph Ninth to read (R. 13, 20):

> "Ninth: This Indenture and all of the provisions thereof are irrevocable and not subject to alteration, change or amendment."

In 1934 the two daughters received the entire net income of their respective trusts and in 1935 they received nearly all of the net income. John received about one-fourth of the net income of his trust in 1934 and a slightly larger proportion in 1935 (R. 13, 14).

The question is whether, in view of the language of the trusts and the evidence as to the intent of the grantor, there is any provision in the Revenue Act of 1934 which justifies the taxation of the grantor on account of the

income which was in fact distributed to the named beneficiaries in 1934 and a part of 1933 and the income accumulated for their benefit.

II.

There Is No Provision of the Revenue Act of 1934 Which Supports the Government's Contention in This Case.

The contention of the Government appears to be a simple one. It is contended that no donor can escape payment of an income tax on property which he transfers to members of his intimate family group as long as such property is held or owned or enjoyed by such transferees and the intimate family group is maintained. Government counsel rely on sections 166 (2), 167 and 22 (a) of the Revenue Act of 1934 to sustain this contention, but section 22 (a) is in fact required to make good their claim, because it is necessary to invoke the intimate family group theory in order to support the contention that a transferee member of a family group who has ownership and control of such property still does not have an interest adverse to the grantor. This theory, but not in the form now asserted by the Government, was discovered by this Court to be embodied in section 22 (a) when it decided *Helvering* v. *Clifford*, 309 U. S. 331. Section 22 (a) has been a part of the Revenue Acts in substantially the same form since 1913, and if it supports the contention now made by Government counsel then there was never any reason for the enactment of sections 166 and 167. All that is contained in those sections and more too was already contained in 22 (a). Apparently neither Congress nor the Treasury Department was aware of this when sections 166 and 167 were enacted. At any rate, the full contention of Government counsel can be supported, if at all, only by section 22 (a), which includes the theory based upon the relationship of

members in an intimate family group, and it is necessary to consider the Government's complete contention.

Not only does the decision in the *Clifford* case fall short of the Government contention, but the decision in *Richardson* v. *Commissioner*, already referred to, in which case this Court denied certiorari, is inconsistent with their contention. In that case the taxpayer was the trustee of trusts created by his wife for the benefit of their children. The Circuit Court of Appeals for the Second Circuit held that the broad powers conferred upon the husband, as trustee, were sufficient to give him substantial ownership of the trust property, and that therefore there was more reason for applying section 22 (a) to tax him in such a case than there was to apply that section to tax the grantor in the *Clifford* case. This case shows that the doctrine of family solidarity is not confined to the taxation of grantors. Otherwise it was the wife, the grantor, and not the husband, the trustee, who should have been taxed in the *Richardson* case. It was not claimed that the husband did not have an interest adverse to the wife, nor was it claimed that the husband would return the property to her if she asked for it and that she must therefore be regarded as the taxpayer.

The only way of avoiding the decision in the *Richardson* case is for Government counsel to claim that the grantor in the case at bar could be taxed as well as the wife and brother, and that the right to tax the wife and brother does not defeat the right to tax the grantor. This would constitute an admission that their interests are adverse and would defeat the Government's contention so far as section 166 is concerned. As to section 22 (a) it is clear that in the *Richardson* case the tax was sustained against the husband, not because his wife was the grantor nor because, on account of their relationship, it was assumed that either the grantor or the husband or both might have been taxed. The husband was taxed because he was the substantial

owner of the property, having power to terminate the trust, and the income was to be used for the benefit of his children who were within the intimate family group.

There is no basis, therefore, for any contention that the decision in the *Richardson* case would justify the taxation of the wife, the grantor in that case, as well as the husband who had complete control of the trust property. If the grantor had been an uncle or a cousin or an aunt of the wife's and the husband had been made the trustee, with the same powers, the husband's interest would be clearly adverse to that of the grantor, and yet he would still have been taxed because the ownership and the beneficial interest would have remained in an intimate family group. The economic benefit to the husband would be just the same as it would be if he had received the property from the uncle or the cousin or the aunt and made the trust himself. In the case at bar it is the wife and brother who are claimed to have the power to do anything they like with the trust property, appropriate it for themselves or for any one else as they see fit. On that theory they should have been taxed, not the grantor.

In attempting to tax the grantor in this case the Government is confronted with a further difficulty in regard to the transfer of the property to the grantor. Under paragraph Eighth of the trust the grantor is permitted to withdraw securities in the trust only if they are replaced by other securities of equal market value. The wife and the brother, even if they were not trustees, would not be permitted to aid the grantor to disregard the provisions of paragraph Eighth and terminate the trust. That is the difficulty with the first step in the Government argument—that the wife and brother can ignore their fiduciary obligations and relieve the grantor of his obligations also.

This trust was not a temporary trust, as was the trust in the *Clifford* case nor was it a temporary reallocation of

income between husband and wife. It was a permanent provision for the respondent's children and their separate intimate family groups.

Since the decision in the *Clifford* case there have been a great many cases in lower federal courts and in the Board of Tax Appeals involving the application of section 22 (a). In some of the cases the courts have frankly expressed the difficulties encountered in applying the theory of the intimate family group. See, for instance, the following cases:

Berolzheimer v. *Commissioner*, 116 F. (2d) 628, 630—C. C. A. 2nd.

Commissioner v. *Barbour*, 122 F. (2d) 165, 166—C. C. A. 2nd.

Commissioner v. *Bateman*, 127 F. (2d) 266, 271, 274—C. C. A. 1st.

Suhr v. *Commissioner*, 126 F. (2d) 283, 287—C. C. A. 6th.

Commissioner v. *Chamberlain*, 121 F. (2d) 765, 766—C. C. A. 2nd.

Helvering v. *Elias*, 122 F. (2d) 171, 172—C. C. A. 2nd.

Commissioner v. *Branch*, 114 F. (2d) 985, 987—C. C. A. 1st.

Commissioner v. *Prouty*, 115 F. (2d) 331, 337—C. C. A. 1st.

The Circuit Court of Appeals for the Second Circuit has stated the problem as follows (*Commissioner* v. *Barbour*, 122 F. (2d) 165, 166):

"* * * When once the legal difficulties have been overcome of attributing to a grantor for tax purposes income not his under the state law, some practical rule ought to be devised which will indicate with reasonable certainty what trusts are to be taxed against grantors and will not leave each new set of circumstances to be dealt with as a fresh problem. It would seem reason-

able to say that the income of trusts which are not substantially longer than the one in *Helvering* v. *Clifford* are to be taxed against the grantor if he retains the reversion and the income of the property originally in his hands remains 'within' an intimate family group.' "

The truth is that formerly income by definition meant some payment or gain to a person who was entitled to claim it as income. Section 22 (a) was aimed at that person at any rate, no matter from what source the income came. It was the existence of that person that made the payment income. If that person could not be found and the money or other property was otherwise disposed of, it would not be income. There are many corporations which have persons listed as stockholders who cannot be found and to whom dividend payments cannot be made. The unclaimed amounts may never become income to anyone; they certainly cannot be attributed as income for tax purposes to someone not entitled to the dividends. The same thing is true of all capital investments, including trusts.

The beneficiary of a trust who is named as the person to whom income is to be paid by the trustee can certainly be taxed on that income under 22 (a), no matter how small may be the equitable interest from which the income is derived. The tax does not depend upon legal ownership of the property which produces the income, but may accrue from an "interest in such property," to quote the words of the section. The opinion in the *Clifford* case refers to page 12 of the opinion in *Blair* v. *Commissioner*, 300 U. S. 5. This Court is there referring to "the owner of the beneficial interest" in property and states that "the one who is to receive the income as the owner of the beneficial interest is to pay the tax." In *Irwin* v. *Gavit*, 268 U. S. 161, this Court also pointed out that "a gift of the income of a fund ordinarily is treated by equity as creating an interest in the fund." This Court then said (pp. 167-168):

"Apart from technicalities we can perceive no dis-

tinction relevant to the question before us between a gift of the fund for life and a gift of the income from it. The fund is appropriated to the production of the same result whichever form the gift takes."

It is obvious, therefore, that in every case of a trust which cannot be treated as a mere sham, and is in fact no trust at all, there is a difficulty in assessing an income tax against any person other than the beneficiary who is to receive the income and who is the owner of the beneficial interest. No doubt 22 (a) does tax the named beneficiary on the income from such a source, and in the case at bar it is the duty of the trustees to distribute the income as directed until a valid change is made in the trust.

The Government theory in this case seems to be that the income can be taxed to the grantor even though the named beneficiary with the beneficial interest has received it and kept it. This requires the assumption that the beneficiary has received it and kept it for the economic benefit of the grantor. Under this theory the economic benefit to the grantor continues throughout the time the beneficiary receives and enjoys the income because of the family solidarity, and that economic benefit is taxed as income to the grantor, even though the income proper has been paid to the named beneficiary who is the owner of the beneficial interest. It is assumed that the beneficiary would be willing to give the amount of the income to the grantor if he asked for it, or that the grantor derives an economic benefit if the beneficiary keeps it, but it is not denied that the beneficiary was entitled to the income, and did receive it. The family solidarity theory eliminates the possibility or the necessity of any gift either way. At the end of each taxable year an income tax would accrue against the grantor under each trust in this case without any further action on his part or on the part of the beneficiary, or on the part of the wife and brother, and in the

meantime the beneficiary would have received some kind of non-taxable income from Heaven or the Government.

The Government evidently evolved this theory in order to provide more taxes, but it may not always work that way. It may operate very satisfactorily as a gift from the Government to the old folks who would like to turn over something to younger generations in an intimate family group. A parent, for instance, has a brilliant son who is making a very good earned income, but, as he has to pay a good part of it in taxes, he cannot save as much as he would like. So this parent creates a five-year trust with the idea of having the son get some tax-free income which isn't a gift to him. The parent pays the income tax on account of the economic benefit which he derives from the income paid to the son. It may very well be less of a tax than the son would pay if the income were taxed to him, and, in any event, the tax and the income both serve to reduce the amount of property which may be subject to estate tax when the parent, at the end of one, two or perhaps three five-year trust periods, happens to die. Perhaps it is only fair that the old folks should have some of the tax terror removed from their declining years.

Very likely the Revenue Bureau has never intended that the family solidarity theory should operate in any case in which a tax advantage could be secured by the intimate family group. The purpose of the theory obviously was to prevent what is called tax avoidance. However, there is nothing in the opinion in the *Clifford* case to suggest that this theory, based upon 22 (a), was just a one-way street leading to higher taxes. It was not hinted that the one member of the intimate family group who had the highest income could be considered, for tax purposes, the recipient of all of the family income because of some economic benefit he might get from all of it. It may be an economic advantage to a father when his son or daughter becomes of

age and goes to work or gets married, but it has not yet been suggested that in that case the father, because of 22 (a), should add the income of the son or daughter to his own for tax purposes.

In the case at bar the question seems to be whether the grantor can be taxed because he originally owned the trust property and presumably pays the highest taxes in his family group, or whether the wife and brother, who are claimed as individuals to have complete control and ownership of the trust property, should be taxed on the authority of the decision in the *Richardson* case, or whether the children who actually got the income should be taxed. Perhaps the brother should be taxed on all the income because he is outside the grantor's intimate family group and may be assumed to be the real possessor of the power granted in Paragraph Ninth. Then, after the R. D. Stuart trusts were created, each brother would be taxed, not on the income of the trust created by him, but on the income of his brother's trust. Or, better still, perhaps a combination of the grantor theory and the *Richardson* case theory would permit John Stuart to be taxed on the income of his own trust and the income of his brother's trust also.

The intimate family group idea certainly does create difficulties. In Hollywood such a group might be expected to break up even within five years, and the courts in California might be expected to take judicial notice of that probability. Does a trust that isn't a trust become a trust if the family group breaks up? The Board of Tax Appeals thinks estrangement between husband and wife resulting finally in a divorce would make a difference in the application of the family group idea to income taxes. (*Jergens* v. *Commissioner*, C. C. H. Decision 11,842-B.) If later the couple remarried, then what? Obviously, without any change in a trust, the tax on the income might be due for part of a year from one member of an intimate family

group and for the rest of the year from another member. But this would mean merely more revenue agents and new Treasury Regulations requiring reports revealing intimate facts regarding intimate family groups. The case at bar also illustrates the necessity for regulations or decisions defining the extent of intimate family groups. The marriage of John Stuart's children, at the time the trusts were made, created new intimate family groups and there is no decision which holds that such family groups are to be included in the intimate family group of the grantor.

It is not necessary to burden this Court with a reference to the very many cases that have arisen in the lower courts and in the Board of Tax Appeals since the decision in the *Clifford* case. There is no case in which the problems peculiar to the case at bar have been discussed, and there is no case which considers the possibility of taxing both the beneficiary of a trust who receives the income as well as the grantor who does not in fact receive it and perhaps others.

Government counsel refer to *Helvering* v. *Horst*, 311 U. S. 112, as a case arising under section 22 (a). We are not directly concerned here with the decision in that case, but it may be well to refer to certain questions not discussed in the opinion in that case in order that the distinction between income such as wages may not be confused with income derived from trust property or other capital investments. When a person buys a bond he makes a capital investment in the whole bond, including principal and coupons. If he sells some coupons he is making a sale of part of his capital investment and may have a question of capital gain or loss to consider. If, after he sells some coupons, he also sells all of the investment he has left, the bond and the remaining coupons, he will have disposed of all of his investment and will have only a capital gain or loss question to determine. There may be some difficulty

about the question of accrued interest because of the treatment of capital gains as income, and some accrued interest may not be realized as income by anyone. No similar problem arises on the assignment of wages. Earned wages can be income only to the person who earned them. Such person can assign the amount of his wages but not his income. In the case at bar we are concerned also with a capital investment problem—income arising out of a beneficial interest in property. It is not similar to a salary or wage income; the income cannot be separated from the beneficial interest.

In the case of *Harrison* v. *Schaffner*, 312 U. S. 579, also cited by the Government (Br. 29) a new problem would have arisen if the life beneficiary, after making the gift there in question, had assigned to someone else the balance of his beneficial interest in the trust. We believe that the opinion in this case does definitely recognize the legal risk of attributing income for tax purposes to the grantor or any person other than the person designated as the one entitled to it. The decision evidently means that such a thing can be done only when it can be assumed that conditions and relationships will not change during a very temporary period.

We submit, therefore, that under the decisions of this Court and of the other federal courts the one person who clearly is not subject to an income tax in this case is the grantor. If the beneficiaries who in fact received most of the income should not have been taxed, then the only other persons who could be taxed under any decision so far are the wife and brother of the grantor. If we accept the Government's own contention that the wife and brother, by reason of Paragraph Ninth of the trust, became the real owners of the trust property then they, under the decision in the *Richardson* case, should have been taxed. That case also negatives the idea that the grantor could be taxed in their

place by assuming that they would transfer the property to the grantor if he asked for it. Their interest must be adverse to the grantor. The income tax question is disposed of by the fact of their ownership of the trust property and not by what they might do with the property. Of course we deny any such ownership. We are concerned merely to point out that the Government's own contention disposes of any tax against the grantor.

III.

The Law of Illinois Gives No Support to the Government Contention in This Case.

So far the State of Illinois has not imposed income taxes. Under the law of Illinois the word "income" means what it meant before the Sixteenth Amendment was adopted. It is not something which can be defined as income without reference to the person entitled to it.

This Court has recognized that the law of Illinois may have something to do with determining the person who may be subjected to an income tax by the Federal Government; it may determine the rights of beneficiaries under a trust and the extent of the powers of a trustee. *Morgan* v. *Commissioner*, 309 U. S. 78, 82; *Blair* v. *Commissioner*, 300 U. S. 5.

Government counsel now seem to think so, though in the court below they contended that it was a sufficient answer to our contention to say it could be assumed that the beneficiaries, being in the intimate family group, would raise no objection if the wife and brother returned the trust property to the grantor and terminated the trust. But the assumption that the married daughters are now in the grantor's intimate family group is not justified.

It is clear that the Government contentions in this case are in direct conflict with the decisions of this Court in the

cases cited above. As we have said, the Government contention means that a grantor can never escape the income tax on property which he transfers in trust if the control of the property remains in members of the intimate family group. If only persons within such family group have interests in the trust property, then they could always get together with the grantor and terminate the trust. In this case the complete control of the property is asserted to be in the wife and brother, and therefore it is claimed that the grantor has not escaped the income tax. If the beneficiaries were all members of the intimate family group then, of course, they could all join with the grantor in changing or terminating the trust, and so, in that case also, the grantor could not escape the income tax on the trust property. That practically eliminates family group trusts altogether for income tax purposes, and should also eliminate gift taxes in the case of gifts within the intimate family group. It could be assumed by parity of reasoning that the donor could always get his gifts back for the asking.

Needless to say there are no decisions in Illinois which give support to the Government theory. The courts in that state have been sufficiently familiar with controversies in intimate family groups to know that a wife may disagree with a husband regarding property rights, and that children may be only too glad to keep property that is provided for them by a parent. It is not unknown that a wife may prefer a child to her husband in property matters. The *Blair* case recognizes that transfers within a family group may result in a new income taxpayer and that the question of who shall pay the income taxes may depend upon the law of the state.

The suggestion made by the Government in this case—that "the wife and brother could have transferred the corpus back to the grantor without interference by a court

of equity" (Br., p. 17) indicates a lack of familiarity with courts of equity in Illinois. As we have said, the statement does at least indicate a recognition of the fact that a court of equity in Illinois might have something to say about it that would be of interest. We believe it would be difficult to state a stronger case for "interference by a court of equity."

In the first place the intent of the grantor is of first importance. That is shown not only by the trusts themselves but by the evidence in the record. The grantor parted with only a small fraction of his entire possessions. He did it at a time when his daughters were establishing new intimate family groups, and he did it to make them in matters of property not only independent of him but independent in such respects in their new intimate family groups. The purpose was sound, normal and wholly human. No one but a revenue agent could think of any ground for suspicion. The whole of the trust instruments testify to the creation of permanent and not temporary trusts, but with discretion vested in the wife and brother to see that the true purpose of the trusts, the welfare of the grantor's children, should be secured. Undoubtedly the trusts testify to the complete confidence which the grantor had in his wife and brother, not to enable them to terminate the trusts but to enable them to accomplish his full intent. No power to terminate the trusts is expressed and there was no occasion for considering it. The evidence shows the financial position of the grantor and the reason why in 1930 he should be particularly concerned about making permanent provision for the independence of his children. The broad powers conferred upon the wife and brother are not inconsistent with this. They indicate merely his wisdom in recognizing that unforeseen events may happen in the lives of his children and that it will be well to have some responsible persons in a position to act.

In view of this picture the authorities which counsel cite in their brief (p. 17) have no application. They are cited to show that a court of equity cannot interfere with the exercise of an unlimited power when the power is not a power in trust, but the Government's contention that the wife and brother would not be acting as trustees, although they are trustees, does not meet the difficulty. They would be violating their duty as trustees if they permitted the grantor to keep the trust property without substituting new securities of an equal value, as required by Paragraph Eighth. That is a question which the beneficiaries could raise, and there can be no doubt about the answer of a court of equity. There is no express provision in Paragraph Ninth that the wife and the brother can do what is expressly prohibited by Paragraph Eighth or can defeat the whole purpose of the trust by terminating it altogether. No such questions were presented in *Reinecke* v. *Smith*, 289 U. S. 172, which counsel cite (Br. 17). In that case there was express authority for revocation—it was specifically mentioned.

The cases cited in the opinion of the court below, and referred to in the Government brief (p. 17), are therefore directly in point. In the case of *Frank* v. *Frank*, 305 Ill. 181, the possessor of a power thought she had an absolute power and attempted to exercise it as though it were absolute, but the court held that the power was limited by the granting instrument and that she could not exercise it as she pleased to the detriment of one of her children. In the case at bar it is clear not only that the powers expressed in Paragraph Ninth are limited by Paragraph Eighth, but also that those powers, even had there been no Paragraph Eighth, would be held by a court of equity to be limited so that no power or discretion could be exercised arbitrarily to the injury of the beneficiaries named in the trust. Paragraph Ninth must be construed with all the other provisions of the trust and cannot be considered

as conferring a power to defeat the expressed purpose of the trust. Even for the purpose of collecting income taxes it could not be held that all the gifts over contained in these trusts were put in merely for the purpose of concealing an intention to accomplish some tax evasion.

We submit that the Revenue Acts and the law of Illinois permit a grantor, in the normal situation that existed in this case, to create beneficial interests in trust property for his children, and at the same time give the broadest powers to persons in whom he has confidence to act for the benefit of his children when they deem it necessary, without being held still to be the owner of the property so transferred. It has not been supposed before this that even 22(a) was designed to revolutionize the law of future interests, which was already in a state of confusion, and enable revenue agents to shift trust interests so that the largest amount of income taxes could be secured from an intimate family group. At any rate in this case, even if we accept the Government's own interpretation of these trusts, they have pursued the wrong taxpayer and the grantor must go free.

We submit that the judgment should be affirmed.

HERBERT POPE,
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WILLIAM D. MCKENZIE,
Of Counsel.

October 16, 1942.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 48

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

JOHN STUART,

Respondent.

PETITION BY RESPONDENT FOR REHEARING.

HERBERT POPE,
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BENJAMIN M. PRICE,
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THE GUNTHORP-WARREN PRINTING COMPANY, 210 WEST JACKSON, CHICAGO

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PETITION BY RESPONDENT FOR REHEARING.

We respectfully petition this Court for a rehearing in this case.

I.

The order of this Court in reversing the Circuit Court of Appeals and remanding the case to the Board of Tax Appeals for further findings with reference to the application of Section 22(a) of the Revenue Act is based upon a misapprehension of the record before the Board of Tax Appeals. On page 3 of its opinion this Court says:

> "In answer to the taxpayers' petitions for the redetermination of the deficiencies, the Commissioner asserted the increase was required by the provisions of Sections 22, 166 and 167 of the Revenue Act of 1934, 48 Stat. 680."

This is not the fact in No. 48, the John Stuart case, with reference to Section 22. The original claim was based on Section 166. At the hearing and after the decision of this Court in *Helvering* v. *Clifford*, 309 U. S. 331, an amendment to the answer to the petition was made to include Section 167, but, after some discussion, Section 22 was intentionally omitted (R. 11), although it was included in the amendment in No. 49, the R. Douglas Stuart case (R. 12). The right to a finding under Section 22(a) was therefore waived in the John Stuart case at the time of the Board hearing, and the Government brief in the Circuit Court of Appeals, page 30, stated that "Section 22(a) was not relied upon by the Commissioner before the Board of Tax Appeals."

In the Circuit Court of Appeals Government counsel raised the question of the application of Section 22(a) but expressly limited its application to the facts contained in the stipulation. For the purposes of argument we have been willing to discuss in this Court all the possible legal theories involved in the record already made, but the power of the Board to make any special findings with reference to Section 22(a) was barred when this case was before the Board and the question of amendments to the answer was finally determined.

This Court bases its order to remand the case to the Board on the assumption that "When the Board of Tax Appeals decided these cases under Section 166 it was not necessary for it to reach a conclusion on 22(a) or its effect upon Section 167." (Page 10.) This was not in fact the situation before the Board. Even if the Board had been satisfied that the Commissioner's claim could not be sustained under Section 166, the Commissioner's right to have findings made with reference to Section 22(a) had been waived and the Board had no power to deal with that Section. No such power can now be conferred upon it by this Court in view of its decision in *Helvering* v.

Wood, 309 U. S. 344, 348-349. Moreover, in the Court of Appeals the Government attorneys stated that, so far as Section 22(a) was concerned, "the basic facts are those contained in the stipulation."

This Court recognizes in its opinion, page 8, that findings with reference to Section 22(a) could be justified only because that Section had been "pressed continually since this litigation started." In view of the fact that the Commissioner intentionally waived consideration of Section 22(a) when his answer was amended to include Section 167, although he had Section 22(a) in mind and included it in his amendment to his answer in the R. Douglas Stuart case, No. 49, there is no ground upon which it can be claimed that Section 22(a) was pressed continually from the time the litigation started. On the contrary, the Commissioner intentionally left Section 22(a) out of the John Stuart case, and therefore did not assume the burden of proving a case under Section 22(a), which he would have been required to do under Rule 32 of the Board's Rules of Practice if that Section had been included in the amendment to his answer.

We respectfully submit, therefore, that this Court should reconsider its order in this case and should enter an order affirming the judgment of the Circuit Court of Appeals.

II.

If, for some reason which we do not understand, this Court should be still of the opinion that the Board of Tax Appeals is authorized to make special findings with reference to the application of Section 22(a) in this case, then we respectfully ask that this Court first reconsider the consequences of its opinion in this case. We believe its opinion involves a fundamental conflict with prior decisions of this Court, and that this conflict should be resolved before its implications are disclosed to the Board of Tax

Appeals and an unsuspecting public. The conflict concerns not only who owns income but what is income.

We refer first to the statement on page 9 of the opinion, which reads:

> "Economic gain realized or realizable by the taxpayer is necessary to produce a taxable income under our statutory scheme. That gain need not be collected by the taxpayer."

And again on page 10 it is said:

> "In *Corliss* v. *Bowers*, 281 U. S. 376, he (the taxpayer) had disposed of the *res* but with a power to revoke at any moment. This right to realize income by revocation at the settlor's option overcame the technical disposition."

We submit that this theory of taxing a person who does not in fact receive income, instead of the person who has received it in accordance with the applicable state law, because the former has a "realizable" economic gain is in direct conflict with the theory on which "realized" capital gains have been held taxable by this Court while "unrealized" but "realizable" gains have been held not to be taxable. When this question was raised some twenty-two years ago, it was necessary for this Court to consider its decision in the early case of *Gray* v. *Darlington*, 15 Wall. 63. In that case it had been held that increase in the value of an investment through a series of years did not constitute income in any of the years in which the increase occurred nor in the year of the sale. However, in *Merchants Loan & Trust Company* v. *Smietanka*, 255 U. S. 509, and in other cases decided in 1921, it was held that "realizable" gains not in fact realized by a sale or exchange were not taxable, but that gains "realized" through a sale were.

Certainly it is just as easy to sell a marketable security which has increased in value as it is to revoke a trust. It may be easier to sell such a security than it is to persuade a reluctant member of an intimate family group to revoke

or terminate a trust, particularly if there is a question as to his being liable for a breach of trust. Not only that, but in the case of the increase in value of a capital asset the economic gain may be substantially "realized" even without a sale. The increase in value will enable the owner to borrow more money on his capital investment. Certainly the purchaser of land who discovers it possesses oil or gold has a "realizable" gain of a very definite kind. If he is not taxed just because he does not sell it, it must be because "realizable" economic gains do not constitute income for him, or did not until the explicit statement made in the opinion in this case that "realizable" economic gains are included in "our statutory scheme."

There can be no doubt that if this new "realizable" economic gain theory were now to be applied to the increase in the value of capital assets, the industrial life of the country would come to an end almost over night, even in the midst of a war. That is no reason, of course, for rejecting the theory unless the other alternative be deemed to be a better one. It may be less disturbing to the economic welfare of all of us for this Court to reconsider whether the grantor in a trust instrument should be taxed, on account of income actually received and used by a beneficiary, because the grantor might have done but did not do something which would have made him the recipient of the income which was in fact received by the beneficiary.

In *Corliss* v. *Bowers*, 281 U. S. 376, we find the following sentence (p. 378):

> "The acquisition by the wife of the income became complete only when the plaintiff failed to exercise the power that he reserved."

The obvious comment, except for the "realizable" income theory, is to inquire why the wife was not the only person entitled to the income until the power to take it away from her was exercised. Such revocable trusts were the kind of trusts that sensible people made before the

income tax and gift tax era. If conditions remained as expected, there was no reason for a change. If conditions did change, health or financial conditions, there was an opportunity to alter the trust to correspond with changed circumstances. In the meantime, the income of the beneficiary was as fully protected as it could be by the same family solidarity that is now made the reason for taxing the grantor for his enjoyment of "realizable" income. Section 22(a) provides by its terms for the taxation of a person who receives income from an equitable interest in trust property.

We are confronted now with the fact that under the provisions of the same instrument one person may be taxed because he has received and is in possession of "realized" income, and another person may be taxed at the same time for the same income because it is or was a "realizable" economic gain for him. What language is there in Section 22(a) which accomplishes such an extraordinary result as this? If it is not permissible to tax both persons at the same time for the same income, then there must be some language in 22(a) which distinguishes between them and tells when one is to be taxed and when the other. What is it? Where in the "statutory scheme" is there a solution of this problem? Is it always the person with the higher tax? It is certain that the "realizable" income tax theory has no conceivable boundaries and that the possibilities of double taxation for the same income are without limit. The *Merchants Loan & Trust Company* case, *supra*, overruled the half of the decision in *Gray* v. *Darlington*, *supra*, relating to "realized" income and the opinion in this case overrules the other half relating to "realizable" income.

In the *Merchants Loan & Trust Company* case, *supra*, this Court considered that the Sixteenth Amendment as well as Section 22(a) should be interpreted in accordance with what this Court thought the people thought about

income in 1913. Now the new wine of the 1940's is poured into the old 22(a) bottle of 1913 to change and enlarge its meaning even beyond the later express provisions of the 1930's, Sections 166 and 167. The common law rules for the interpretation of tax statutes have been discarded, and, in order to prevent what is called tax avoidance, the meaning of income and the persons to be taxed are subject to constant change under Section 22(a). Both the opinions of the majority and the minority in this case must serve to increase the perplexity of all lawyers and the doubts already expressed by lower federal courts.

No doubt, as this Court says, it is wise to "observe the time-tried admonition of restricting the scope of our decision to the circumstances before us." But a conflict in the decisions of this Court cannot be remedied by the Board of Tax Appeals or the lower federal courts, and too much injustice has been done already to taxpayers in this country by collecting taxes from them based upon inconsistent and conflicting theories. The Board of Tax Appeals cannot settle the scope of the "realizable" income theory by making more findings in this case, and we agree with the statement in the brief of Government counsel in the Circuit Court of Appeals that there are no additional facts which will help to bring this case within any of the Section 22(a) theories so far suggested.

We respectfully ask, therefore, that this Court reconsider its judgment in this case and affirm the judgment of the Circuit Court of Appeals.

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I hereby certify that the foregoing petition for rehearing is presented in good faith and not for delay.

HERBERT POPE,

Counsel for Respondent.